#### Steve Leimberg's Asset Protection Planning Email Newsletter Archive Message #339

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Subject: Ed Morrow: Asset Protection Dangers When a Beneficiary Is Sole Trustee and Piercing the Third Party, Beneficiary-Controlled, Irrevocable Trust

"Many settlors today execute irrevocable trusts for beneficiaries who are or later become sole trustees over a trust in which they are beneficiary. It may be an intervivos or testamentary bypass or QTIP trust for a spouse, or a so-called "beneficiary controlled trust" for a mature child or other beneficiary. Although asset protection professionals invariably recommend against beneficiary-trusteed structures, the common wisdom is still that, as long as ascertainable standards are imposed on distributions and support savings clauses are used, that asset protection and estate tax exclusion for such third party created trusts is achieved. But how secure are such trusts when put to the test?

This newsletter will explore the potential holes in traditional spendthrift protection when a beneficiary is sole trustee and what it could mean for asset protection planning and trusts. More specifically, we'll examine how state statutes seeking to maximize non-judicial powers to amend and terminate irrevocable trusts may be undercutting this protection further by permitting beneficiary/trustees to unilaterally remove a spendthrift clause or terminate a trust."

We close the week with **Ed Morrow**'s commentary on potential asset protection dangers when a beneficiary is sole trustee.

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Here is Ed's commentary:

### **EXECUTIVE SUMMARY:**

Many settlors today execute irrevocable trusts for beneficiaries who are or become sole trustees over a trust in which they are beneficiary. It may be an intervivos or testamentary bypass or QTIP trust for a spouse, or a so-called "beneficiary controlled trust" for a mature child or other beneficiary. Although asset protection professionals invariably recommend against beneficiary-trusteed structures, the common wisdom is still that, as long as ascertainable standards are imposed on distributions and support savings clauses are used, that asset protection<sup>1</sup> and estate tax exclusion for such third party created trusts is secure.<sup>2</sup> But how secure are such structures when put to the test?

This newsletter will explore potential holes in traditional spendthrift protection when a beneficiary is sole trustee and what it could mean for asset protection planning and trusts. First, we'll open with the basics of creditor protection for third party created spendthrift trusts and how bankruptcy courts may have different standards for trust protection than many think. Then, we'll explore how state statutes seeking to maximize non-judicial powers to amend and terminate irrevocable trusts may be undercutting this protection by permitting beneficiary/trustees to unilaterally remove a spendthrift clause or terminate a trust – and what to do about it.

### **COMMENT:**

#### Why the Spendthrift Clause is Important

Let's start with the basic rules if there is no spendthrift clause in a trust.

SECTION 501. RIGHTS OF BENEFICIARY'S CREDITOR OR ASSIGNEE. To the extent a beneficiary's interest is not subject to a spendthrift provision, the court may authorize a creditor or assignee of the beneficiary to reach the beneficiary's interest by attachment of present or future distributions to or for the benefit of the beneficiary or other means. The court may limit the award to such relief as is appropriate under the circumstances.<sup>3</sup>

§ 56 Rights of Beneficiary's Creditors<sup>4</sup>

Except as stated in Chapter 12 [dealing with spendthrift trusts], creditors of a trust beneficiary, or of a deceased beneficiary's estate, can subject the interest of the beneficiary to the satisfaction

of their claims, except insofar as a corresponding legal interest is exempt from creditors' claims.

So, for instance, in a case where a father drafted an irrevocable trust pro se for his daughter, omitting a spendthrift clause, the bankruptcy court attached the daughter/beneficiary's \$600/month income interest. The trust interest was NOT excluded from the bankruptcy estate.<sup>5</sup> In a similar trust case where a spendthrift provision was absent, the debtor/beneficiary's pledging of his twenty year income interest in the trust as collateral for a loan was honored and the creditor permitted to pursue its secured interest from the trust.<sup>6</sup>

Once a spendthrift provision is disregarded, a bankruptcy court will bring the debtor/beneficiaries interest into the bankruptcy estate, overriding the usual bankruptcy exclusion of 11 USC S541(c)(2). This could be especially dangerous for mandatory income trusts such as the *Delmoe* and *Oelrich* cases cited above, and worse for time-stepped distributions wherein 1/3, 1/2 and/or eventually the entire trust corpus is to be distributed to a beneficiary outright at a certain age.

Not surprisingly, a self-settled trust (irrevocable or not), with a spendthrift provision is clearly ineffective as to the settlor under state law (except possibly for irrevocable trusts created under specific self-settled domestic asset protection trust statutes) and thus will be included in the settlor/beneficiary's bankruptcy estate. More surprisingly and alarmingly, a joint revocable trust can jeopardize contributions of the non-debtor spouse.<sup>7</sup>

Of course, such cases involving truly third party settled irrevocable trusts *without* a spendthrift clause are extremely hard to find, since nearly every irrevocable trust has one. It would probably be malpractice to omit it, with the possible exception of certain self-settled tax advantaged trusts wherein a settlor may want to give beneficiaries the ability to sell or transfer the interest or it would not be effective under state law anyway.<sup>8</sup> Even the simplest spendthrift clause can protect most trust interests (excepting self-settled trusts) from creditor claims in state court or bankruptcy court.<sup>9</sup>

That said, the important term is "applicable nonbankruptcy law".<sup>10</sup> If the relevant state law (e.g. California, New York) permits 25% of irrevocable trust distributions to be garnished unless needed for support of self and

dependents, despite a valid spendthrift clause, then up to 25% of a trust could be included in a debtor/beneficiary's bankruptcy estate, and at least 75% excluded.<sup>11</sup> If the state law applicable to the trust and the law of a debtor/beneficiary's residence differ, the law stated in the trust is *likely* to control. However, this determination requires a complicated and, frankly, unpredictable analysis of conflicts of law, requiring examination of which state has the most substantial relationship to the issue, residency of the settlor, trustees and beneficiaries, and the location of assets and administration.<sup>12</sup>

Even if a state, as many do, has exceptions to spendthrift protection for certain creditors, such as domestic support obligations (alimony and child support), necessaries or taxes, the trust will still be considered as completely excluded from the bankruptcy estate pursuant to 11 USC §541(c)(2).<sup>13</sup> The bankruptcy trustee usually assumes the role of general creditor, not a special unique spendthrift trust exception creditor such as a spouse, child or the IRS.<sup>14</sup> That said, the bankruptcy code section that permits avoidance of fraudulent transfers, §544, speaks to "a creditor", and several district courts have held that the bankruptcy trustee steps into the shoes of the IRS (if they are a creditor, which is often) for purposes of the longer 10-year statute of limitations applicable to the IRS, IRC §6502, which preempts state law, which is often only 2-4 vears.<sup>15</sup> This effectively gives bankruptcy trustees a ten-year lookback to contest fraudulent transfers whenever taxes are owed, which is totally separate from the more commonly discussed ten-year lookback vis a vis transfers to "self-settled trusts or similar devices."<sup>16</sup>

While the vast majority of trusts will contain an express spendthrift clause, some states will even impose the spendthrift restriction as default by statute.<sup>17</sup> The Uniform Trust Code is extremely liberal in construing a trust as creating one – no elaborate drafting is needed.<sup>18</sup> The fact that a beneficiary happens to also be trustee is usually not fatal, and is expressly protected if ascertainable standards on distributions to the beneficiary/trustee are imposed (with potential exceptions to be discussed shortly).<sup>19</sup>

This article will not discuss obvious and abusive alter ego or sham trusts that attempt to hide the true settlor/grantor of the trust. These can be pierced on different theories.<sup>20</sup>

No doubt, reader, you agree with the importance of a spendthrift clause and are nonplussed, since you would never draft a trust without one, and may have never even *seen* a trust without one. Let's discuss some case law exceptions to this general rule before we explore how decanting statutes, uneconomical trust termination statutes and possibly others may unwittingly threaten this tentative protection even further when a beneficiary is the sole trustee.

# Case Law Exceptions to Protection for Beneficiary Dominion and Control

The most surprising find for estate planners reading through bankruptcy case law is to find out that the mere existence of an anti-alienation provision may not in and of itself qualify the trust as a spendthrift trust. A court may well go beyond basic state spendthrift law to examine "other provisions which may mitigate against such a finding".<sup>21</sup> This Southern District of Ohio case adopted the following test:

The *Gallagher* court concluded that a trust that contains a spendthrift provision cannot be a spendthrift trust if: (1) the settlor of the trust is also the beneficiary of the trust; (2) the beneficiary has dominion and control over the trust; (3) the beneficiary may revoke [\*\*11] the trust; **or** (4) the beneficiary has powers in the trust. <u>*Gallagher* 101 Bankr. 594, 600</u>, citing <u>*Swanson*, 873 F.2d 1121, 1124</u>; <u>*O'Brien*, 94 Bankr. 583, 587</u>. The existence of such powers rather than the exercise of the powers deny spendthrift status. <u>*Swanson*, 873 F.2d 1121, 1124</u>.

In determining whether such defects exist, the overriding policies of the Bankruptcy Code must be kept in mind. It is the policy of the Code to enlarge the bankruptcy estate to the extent possible under the Code in an effort to provide creditors with the distribution to which they are entitled. Accordingly,  $\frac{541(c)(2)}{2}$  must be narrowly construed to avoid impinging upon the policies sought to be furthered by the Code.

Clearly, the Trust in the instant action contains neither a provision that renders it a self-settled trust, nor a provision that grants the beneficiary revocation powers. Thus, the only remaining question is whether the Trust gives the beneficiary dominion and control over the Trust so as to preclude a conclusion that the Trust is a spendthrift trust.

So, you might be wondering, what abusive and sneaky technique was the beneficiary exploiting in the *Baldwin* case to exercise so much dominion and control so as to negate the spendthrift protection of the trust? Was he using the trust as his de facto checking account? Taking large loans, distributions well beyond ascertainable standards? *No* – the trust merely had a provision that allowed him to fire/replace the independent corporate trustee with another corporate trustee. Because, according to the court, he could have created and appointed a controlled corporation to act as trustee, and because the trust had wide discretionary provisions, the debtor had unfettered control. Moreover, this potential for control is damning even though the debtor *never attempted to assert it*, it was sufficient to simply have the power. The creditor won this case *on summary judgment*!

The usual reaction of attorneys to *Baldwin* is to ignore it as an aberrant case and disbelieve that another court would ever follow it. One court did decline to follow Baldwin's four part test.<sup>22</sup> There is only one case citing *Baldwin* for this test, and it is a truly "bad facts" case.

In *In re McCullough*, spendthrift protection was *denied* in bankruptcy despite an otherwise valid provision in the trust because, while debtor/beneficiary's father was titularly the trustee, the debtor/beneficiary wrote checks from the trust checkbook, used his father's signature stamp, controlled an eTrade trust account, etc. The court stated "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 discloses blatant and unfettered dominion and control over the Trust assets"<sup>23</sup>

In *In re Schwen,* a parent died and left assets to debtor child in trust, with debtor and his sister as co-trustees. This case followed a similar test to the above cases, with instructive discussion of the rationale behind denying spendthrift protection, but in *upholding* protection, it also provides the remedy in its analysis – a bona fide co-trustee and proper administration:

The purpose of a spendthrift trust is to protect the beneficiary from himself and his creditors. <u>*Cattafi*, 237 B.R. at 856</u>. Therefore, such a trust fails where the beneficiary exercises dominion or control

over the property of the trust. *Id.; <u>Bottom, 176 B.R. at 952</u>. In bankruptcy proceedings, the debtor's degree of control over the spendthrift trust is often the primary consideration in determining its validity. <u>Kaplan v. Primerit Bank, 97 B.R. 572, 577 (B.A.P. 9th</u> <u>Cir. 1989)</u>. It is clear that if the beneficiary has absolute and sole discretion to compel distribution of the trust assets, the spendthrift provision must fail. See <u>Bottom, 176 B.R. at 952</u> (noting that the sole trustee and the sole beneficiary cannot be one in the same); <u>Govaert v. Strehlow (In re Strehlow), 84 B.R. 241, 244 (Bankr.</u> <u>S.D. Fla. 1988)</u>. However, something less than absolute control may also destroy the spendthrift character of a trust. <u>Hersloff, 147</u> <u>B.R. at 266</u>.* 

In this case the Plaintiff is one of two co-trustees, both of whom must consent prior to any withdrawal from the trust. The case of <u>McCauley v. Hersloff (In re Hersloff)</u>, 147 B.R. 262 (Bankr. M.D. Fla. 1992), holds that when the debtor is one of three trustees, she does not exercise enough control over the trust to invalidate the spendthrift provision. <u>Id. at 265</u> ("An otherwise valid spendthrift trust will not be disallowed . . . merely because the beneficiary happens to represent a minority of the voting trustees."). The case goes on to note that even if there were only two trustees, the debtor still would not have sufficient control over the trust to invalidate its spendthrift provision. <u>Id. at 266 n.2</u>.

The present case is distinguishable from the *Strehlow* case cited by the Defendant. The court in that case found that a spendthrift provision was invalid because the debtor had sole discretion to compel distribution without the consent of his co-trustee. <u>Strehlow</u>, <u>84 B.R. at 244</u>. Here, the parties agree that the Plaintiff must have the consent of her brother prior to any distribution. Thus, Plaintiff's control is sufficiently limited by her co-trustee to uphold the spendthrift provision.<sup>24</sup>

*In re Pugh* is a very similar case piercing an irrevocable trust on "bad facts". There, a debtor inherited money in trust and was beneficiary-trustee with his sister as co-trustee. However, unlike the *Schwen* case, and similar to *McCollough*, the sister as titular co-trustee had absolutely no role in practice - the debtor/trustee acted without her consent or

knowledge. Therefore the court denied spendthrift protection and included the trust in the debtor's estate.<sup>25</sup>

In *Johnson v. McCoy (In re McCoy),* the debtor, who was a current beneficiary and trustee of a bypass trust created by his late wife, was entitled to all net income, with principal distributed under this clause:<sup>26</sup>

(b) 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 required or desirable for his health, maintenance and support. The Trustee need not consider the interests of any other beneficiary in making distributions to my spouse or for his benefit. Although my primary concern is for my spouse's health, maintenance and support, the trustee may in its discretion during the life of my spouse pay to, or use for the benefit of, one or more of my descendants to the exclusion of one or more of them so much of the principal of the Family Trust as the trustee from time to time determines to be required for their health, education, maintenance and support.

While most attorneys would think this language to be a broad but perfectly acceptable ascertainable standard meriting protection, the court (both bankruptcy and district court on appeal) found that this language granted the spouse/trustee unfettered control and dominion over the trust, a *de facto* general power of appointment, and therefore included the trust in the debtor's bankruptcy estate.

For those of you familiar with the tax area, these cases starts to remind one of the *Atkinson* case, which should be required reading for anyone recommending, administering or counseling trustees of charitable trusts, GRATs, QPRTs and other statutory safe harbor trusts.<sup>27</sup> In that case, a properly drawn and executed trust was denied the charitable deduction both prospectively and *ab initio*, because the beneficiary/trustee did not properly administer the CRT. To the IRS, the lack of administrative compliance violated the terms and therefore the tax benefits of the trust. It should be no surprise that a bankruptcy court would look the same way towards loose or abusive administration of a spendthrift trust by a sole trustee/beneficiary.

Moreover, do not assume that bankruptcy (or even appellate) courts will understand fundamental trust law, much less "beneficiary-controlled trust" nuances. Here is another recent third-party trust piercing case that will surprise readers:

In In re Heifner,<sup>28</sup> Charlotte Heifner died and left her estate to her young son Robert (the debtor/defendant) in trust. In what readers would assume is a very positive and prudent move, the trust did not pay outright to her son, and had a valid spendthrift clause. Contrary to what we might recommend, but what we would not assume to be fatal, the trust directed that 20 guarterly distributions be made for five years after her death. You might think – aha!, the creditor can get at the mandatory distributions that were not made (bankruptcy was filed a year or so after his mother died so five distributions should have been made) – and that would be a logical result, consistent with Ohio's Uniform Trust Code which has specific provisions about that. But the bankruptcy court took a completely different interpretation that threatens many so-called "beneficiary-controlled trusts". Under the trust terms, once Robert reached age 25 (and he was by this point), he was entitled to fire the trustee and appoint himself or another related or subordinate party. As in the other cases quoted above, the bankruptcy court focused on potential *control*, rather than the state law validity of a spendthrift provision. Moreover, the bankruptcy court simply misunderstood Ohio trust law and ignored the remainder/contingent beneficiaries as potential equitable owners. The court's conclusion of trust failure whenever a current beneficiary is trustee (or could be trustee) should not withstand any scrutiny, but it was not appealed.

Lest you think Ohio bankruptcy courts are the only ones that would bust a beneficiary controlled trust because it incorrectly ignores remainder beneficiaries, consider the similar cautionary tale of *In re Scott.*<sup>29</sup> A debtor's mother died and left asset to him in trust. He was a co-trustee with his sister, and beneficiary. He went to court and reformed the trust to remove the requirement for a co-trustee. His sister thereafter resigned leaving son as sole trustee for himself and remaindermen. The bankruptcy court ignored the remaindermen, because his issue were yet unborn and therefore unvested. "Upon her resignation, all legal and equitable title to the Trust assets merged into one person, the Debtor, pursuant to Texas Property Code § 112.034(c), and spendthrift protection was lost.\*\*\* only in a situation where the Debtor is the only trustee and the only beneficiary is spendthrift protection lost, and that is what has occurred in this case. The Trustee [referring to the bankruptcy trustee] does not dispute that a trustee can be a beneficiary; the Trustee simply posits that there is no spendthrift protection if the sole trustee and the sole beneficiary are one and the same. **This Court agrees**."

I completely disagree with the court's conclusions in *Heifner* and *Scott* because they ignored siblings and other possible remainder beneficiaries who would likely have taken if the beneficiary had no surviving issue.

Although many readers would have ruled the other way, especially in the last two cases, we still have the above precedent to contend with. I believe that it is only a matter of time before debtors use additional arguments to pierce such trusts, which brings us the main focus of this paper, which is the potential inadvertent effect of state statutes that expand non-judicial amendments and terminations by sole trustee/beneficiaries.

#### Common Law Decanting Clarified – and Expanded - by Statute

Arguably the power to decant has long been within trustees' powers if there is broad enough discretion to distribute, included as part of a fiduciary limited power of appointment.<sup>30</sup> Sometimes a trust document will grant a limited decanting power (in powers of appointment as well as in distribution powers or perhaps indirectly through in a power to merge or consolidate trusts), whether there is a decanting statute or not.<sup>31</sup>

But for purposes of this article, we'll assume there is a sole trustee/beneficiary with ascertainable standards imposed on distributions to him or herself, thus taking the situation out of the broad common law or the broadest statutory powers to decant. Even with ascertainable standards imposed, however, most state decanting statutes permit an interested trustee to decant.<sup>32</sup> Typically, the right to decant a trust with less than absolute discretionary standards, such as a trust with ascertainable distribution standards, is more limited, and cannot substantially modify the beneficial interest of the beneficiaries.

The only mention of spendthrift clauses in most state decanting statutes, if it is mentioned at all, is simply to state that they are not any impediment to decanting.<sup>33</sup> Decanting clearly permits the addition or removal of spendthrift clauses.<sup>34</sup>

Similar to most state statutes, the recently drafted Uniform Trust Decanting Act (passed in two states already) only mentions spendthrift clauses in passing as not preventing a decanting, and would clearly permit a beneficiary/trustee to remove a spendthrift clause.<sup>35</sup> Although there is a general and robust tax savings clause in the Act (better than most state statutes) to prohibit adverse tax effects, it too would unlikely apply to prohibit removal.<sup>36</sup>

If a trust is not sitused in such a state that permits this, a trust can often avail itself of another state's decanting statute by either changing situs or administration to one of these states to create enough nexus to utilize another state's statute.<sup>37</sup> It's not necessary for an individual trustee or beneficiary to move to such a state to create nexus— it might e.g., involve hiring a trust department as agent for trustee to perform some trust administration in state.<sup>38</sup>

#### Differences Between Decanting and Consolidation and Why the Latter is Less a Threat if Done by Beneficiary/Trustee

Many trusts also grant the trustee the power to merge or consolidate trusts, which effectively can often accomplish the same thing as decanting but without the upscale nomenclature. Someone, even a beneficiary/trustee, can simply establish a new trust with the terms they want and the trustee can merge the current trust into it. Many states have specific statutes as well, such as:

Section 417. Combination and Division of Trusts. After notice to the qualified beneficiaries, a trustee may combine two or more trusts into a single trust or divide a trust into two or more separate trusts, *if the result does not impair rights of any beneficiary or adversely affect achievement of the purposes of the trust.*<sup>39</sup>

Similar to decanting, such consolidations do not require court approval and can be accomplished by a beneficiary/trustee just the same as with an independent corporate trustee. These provisions are not as problematic as decanting because consolidations usually require a higher standard – consolidation cannot "impair rights of ANY beneficiary" (whereas decanting may do so in a variety of ways) and more importantly it cannot "adversely affect achievement of the purposes of the trust". Removing the spendthrift provision would probably do so, since it's hard to imagine a settlor that would not intend to protect his beneficiary's interest from creditors. Note that the purposes here do not have to be "principal" or "material", which are modifiers often used in state statutes regarding trust modifications. Spendthrift protection is often *not* presumed to be a material or principal purpose of the settlor.<sup>40</sup> The italicized restrictions noted above are not present in decanting statutes – most UTC amendment provisions, such as §417, but also §415, §416, are tied tightly to the settlor's intent – decanting is not.<sup>41</sup>

# Contrasting and Comparing Beneficiary/Trustee Powers to Terminate "Uneconomical" Trusts

There is one other unique statutory development that does not necessarily require court or any other party approval - the termination of a small or uneconomical trust with only \$50,000-\$200,000 corpus.<sup>42</sup> This may also typically be done by a beneficiary/trustee on his or her own initiative, and comments to the UTC provision (as well as specific language in many statutes) are quite specific that a spendthrift provision does not preclude a beneficiary/trustee from unilaterally terminating the trust: "Because termination of a trust under this section is initiated by the spendthrift provision."<sup>43</sup>

#### Contrasting and Comparing Beneficiary/Trustee Powers to Amend or Terminate Under Common Law or Non-Judicial (Private) Settlement Agreements with Virtual Representation

Another development that is seeing dramatically increased use in recent years is obtaining an agreement among interested parties to terminate a trust (and/or, of course, any lesser change or amendment) pursuant to common law and/or statutory non-judicial settlement agreement.<sup>44</sup> Although you would think such agreements to be far outside the topic of this article, which involves the potential for a bankruptcy trustee acceding to *unilateral* powers of a debtor to act without others' consent, there has been a vast expansion of virtual representation statutes in recent years.<sup>45</sup> A sole trustee/beneficiary may be able to virtually represent the other beneficiaries of a trust in such an agreement, absent express conflict. For instance, it would not be uncommon for a surviving spouse to hold a testamentary limited or general power of appointment over a bypass or marital trust, or a child to hold such powers over a trust with their own children as remaindermen, enabling virtual representation of appointees and takers in default.

A sole trustee/beneficiary may have a considerable amount of power to act unilaterally under such statutes to amend the trust for their benefit –

how much power would a bankruptcy trustee be able to accede to? Such agreements need not have any negative effect over other beneficiaries' interests. It is my personal conclusion that a bankruptcy trustee should **not** be able to "virtually represent" any party other than the debtor because such a power should be excluded as a power exercised "solely for the benefit of others", to paraphrase §541(b)(1), discussed below. It's likely too much of a stretch for a court to claim such power.

My own conclusions aside, one can easily see the practical, common sense argument to the court – such a power is not "solely" for the benefit of others and it can easily be exercised to only benefit the debtor as long as it does not harm the virtual representees. If the bankrupt has the de facto power to remove their own spendthrift clause or even terminate the trust, why shouldn't the bankruptcy trustee accede to this power as well? While such an attempted usurpation of power is ultimately probably a losing argument in the virtual representation/non-judicial settlement context, that does not mean it would not be prudent to draft clauses that easily cut off any such argument as well.

#### Sole Trustee/Settlor/Quasi-Beneficiary Power to Reimburse or Pay Income Tax of Settlor of Grantor Trust

While this paper primarily concerns potential attacks against sole trustee/beneficiaries of third party created irrevocable trusts, some intervivos third party created trusts contain a power to reimburse a settlor for income taxes payable as a result of any grantor trust attribution. If a trust does not contain such a provision, it can be added.<sup>46</sup> Usually practitioners avoid naming a settlor as a sole trustee of such a trust for various estate/gift tax reasons (and decanting statutes often preclude a settlor/trustee from decanting).<sup>47</sup> However, similar holes in creditor protection could apply if a settlor can be reimbursed even if a completely independent trustee were used. It's really no different from a self-settled trust – the ultimate question being whether state savings statutes that protect such interests will be honored by the bankruptcy court, or pierced under the §548(e) ten-year lookback for fraudulent transfers to self-settled trusts or similar devices or some other theory.<sup>48</sup> Remember the general rule is that bankruptcy courts look to state law to determine the extent of the property interest – what bundle of rights and powers does a debtor have, then to federal bankruptcy law

to determine whether the interest is part of the bankruptcy estate. Statecreated *exemptions* are under a different code section.<sup>49</sup>

#### Third Party Created Irrevocable Spendthrift Trusts in Bankruptcy and Powers Held by Debtor - Does it Include Legal Interests and Powers A Debtor May Exercise For Themselves?

What state debtor/creditor law would conclude from these expanded trustee/beneficiary powers in the various state jurisdictions is beyond the scope of this article, which will only address federal bankruptcy law. Let's quote the statutory scheme that usually grants strong protection for third party created irrevocable spendthrift trusts (and their trustees and beneficiaries) in bankruptcy:

§ 541. Property of the estate

(a) The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:

(1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.

\*\*\*

(b) Property of the estate does not include--

# (1) any power that the debtor may exercise solely for the benefit of an entity other than the debtor;

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(c) (1) Except as provided in paragraph (2) of this subsection, an interest of the debtor in property becomes property of the estate under subsection (a)(1), (a)(2), or (a)(5) of this section notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law--

(A) that restricts or conditions transfer of such interest by the debtor, or

(B) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.

(2) A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title.<sup>50</sup> [emphasis added]

Thus, we start with the broad inclusion of "all legal or equitable interests", but then exclude powers held solely for the benefit of others, and honor restrictions that are enforceable under other state or federal law (i.e., spendthrift protection). The bankruptcy of a holder of a limited power of appointment or fiduciary power held as trustee, executor, or attorney-in-fact should not usually affect the underlying trust. The bankruptcy trustee does not become a trustee, agent or executor in place of the debtor. Powers held *solely* for the benefit of others, such as a limited power of appointment, are sacrosanct and thus most traditional trust powers are therefore excluded from the bankruptcy estate. *But not necessarily all.* 

#### Why Sole Trustee/Beneficiary Powers To Unilaterally Terminate the Trust or Remove the Spendthrift Clause May be Dangerous

A narrow power to remove one's own spendthrift restriction is arguably not a power "solely for the benefit" of others. A decanting might remove the spendthrift restriction only as to the debtor/beneficiary and have no effect whatsoever on other parties' interests.

Let's explore some cases in this area surrounding powers over trusts and trust assets. Not surprisingly, a power to amend and revoke a trust and recover remaining funds would become part of the bankruptcy estate and exercisable by the bankruptcy trustee.<sup>51</sup> Generally, "what comes into the bankruptcy estate is not only the property in which debtor has an interest, but also, *the powers the debtor can exercise for its own benefit over property, regardless of the title debtor may be acting under.*"<sup>52</sup>

Thus, for example, *Crummey* powers and hanging powers held by a debtor/beneficiary would, not surprisingly, be attachable and part of a bankruptcy estate, despite a spendthrift clause.<sup>53</sup>

Another example involves a revocable trust established by a debtor for his mother as primary beneficiary. Although the debtor was **not** a

beneficiary, he could revoke the trust. This power was held to be in the debtor's bankruptcy estate and the bankruptcy trustee acceded to the power to revoke the trust.<sup>54</sup>

Not so different from garden variety revocable trusts are Illinois Land Trusts, which courts have also found to be in a bankrupt's estate: "This result is further supported by the fact that the debtors-in-possession succeed, as would a trustee, to all the powers and rights held by the debtors on the date of filing their petition in bankruptcy. Among those powers is the authority to direct the trustee of the land trust to sell the property and terminate the trust. The exercise of this power would clearly be in the best interest of the estate in this case. Further, the debtors have a beneficial interest in the proceeds of the sale of the res of the trust. Clearly that interest is property of the estate."<sup>55</sup>

These cases are not precisely on point, of course. The above cases concern what is the equivalent of a presently exercisable general power of appointment (aka withdrawal right).<sup>56</sup> For a sole trustee/beneficiary to get access to trust assets equivalent to a presently exercisable general power of appointment requires an additional step – removing the spendthrift clause applicable to the beneficiary/trustee.

For a trustee/beneficiary to invoke an uneconomical trust termination statute, the trust corpus must of course be under the minimal amount outlined by state law.

#### The Chicken or the Egg (§541(a)(1) or §541(c)(2))? Why the Bankruptcy Trustee will probably take control of the Chicken, then the Eggs

Upon the commencement of a bankruptcy case, is the trust initially completely excluded pursuant to \$541(c)(2), thus prohibiting \$541(a)(1)from applying to include the sole trustee/beneficiary's power under such a trust in the bankruptcy estate? Or, can \$541(a)(1) permit the bankruptcy trustee to exercise the debtor's sole power to decant, remove the spendthrift provision, or terminate the trust and thus bring the debtor's interest into the estate, since \$541(c)(2) would *thereafter* fail to apply? There is no case precisely on point. Until there is clearer guidance, it is prudent for planning purposes to assume the latter interpretation even if there is plenty of room for doubt. We'll explore the interplay between these two sections and two lines of cases that point to this conclusion, but first, let's step back with a dose of common sense. Why permit the debtor to get away with in two easy steps what they could not get away with in one step? If there were an express trust provision permitting any beneficiary to unilaterally remove their own spendthrift clause, no one would doubt that protection is completely eroded. We'd scoff at such a clause as flagrant malpractice. Yet, a decanting power (under most state statutes) held by a sole trustee/beneficiary is extremely close and as a practical matter *identical* to this power, *just better hidden*. So is the ability to terminate an uneconomical trust. The ability to take unsecured, no interest loans comes close as well. A bankruptcy court is a *court of equity* and can look through form to the substance of the matter.

The (possibly) important difference is that there are fiduciary standards that limit the debtor trustee/beneficiary from acting in bad faith towards themselves. Of course, the only person with standing to object would be...the same debtor/beneficiary, and while a bankruptcy trustee generally only obtains any rights a debtor would have to sue others for damages for pre-petition actions, it's hard to imagine a successful suit against a bankruptcy trustee for using its power to gather assets and pay a debtor's debts explicitly granted by §541(a).

Debtors would argue that  $\S541(a)(1)$  specifically excludes any trust powers: "(1) Except as provided in subsections (b) **and (c)(2)** of this section, all legal or equitable interests of the debtor in property as of the commencement of the case." True, it clearly excludes what we think of as a traditional spendthrift trust equitable interest from the estate initially, because state spendthrift law ("applicable nonbankruptcy law" referenced in (c)(2)) typically prohibits assignment of such, but does it include all the various powers that may go along with a trust –powers to substitute property, power to borrow, power to fire and replace trustees, powers to revoke or amend, powers of appointment, power to disclaim etc.? These are not typically property rights that state spendthrift laws prohibit assigning, and such *powers* may well be outside of paragraph (c)(2)'s exclusion.

Is the fact that a debtor/beneficiary/trustee's power *fiduciary* meaningful? After all, the statute brings in all *legal* and equitable powers, and only excludes powers *solely* for the benefit of others – there is no explicit exception for *fiduciary* powers. It is altogether possible, however, that a court would not permit a debtor's power as trustee to be parsed in such a manner, divided into powers that might be exercised for the debtor alone and those that might affect others. A beneficiary/trustee's power necessarily includes *both*. Perhaps a court may find that a bankruptcy trustee can only accede to *all* of a debtor's power, which as a trustee includes power to affect remaindermen or other beneficiaries as well, *or not at all*. We'd like to think (unless we represent a creditor) that all fiduciary powers of a debtor that might *in part* be used for others are simply excluded from the bankruptcy estate. But the statute is not quite so clear.

Two lines of cases in slightly different areas may be informative, one regarding LLCs and the other involving other trust busting cases – let's tackle some case law on contract rights of partnership or LLC members or shareholders first. After all, partners and members owe certain fiduciary duties to co-owners as well. Contract rights generally become property of the bankruptcy estate subject to bankruptcy trustee control. The bankruptcy trustee takes contracts of the debtor subject to their terms and conditions.<sup>57</sup> Let's examine how a bankruptcy trustee may extend these contract cases to apply to sole trustee/beneficiaries who have the power to remove a spendthrift clause or terminate an uneconomical trust.

A contractual right does not have to have an easily ascertainable value to be included in the bankruptcy estate. Property of the bankruptcy estate encompasses conditional, future, speculative and equitable interests of debtor (absent the §541(c)(2) exclusion discussed above).<sup>58</sup>

So, when a debtor is a partner in a partnership, the partnership interest is part of the bankruptcy estate, but not the underlying assets of the partnership (or, of course, an LP, LLP, LLC or corporation). But what if a member had other powers associated with the limited liability company or similar entity? For instance, what if the debtor/owner had the right to dissolve the entity?

A debtor's right to seek judicial dissolution of a partnership is property of a debtor's bankruptcy estate over which Bankruptcy Court has jurisdiction. Thus, a bankruptcy trustee can seek dissolution if the debtor could have done so prior to filing bankruptcy – it need not be a single member LLC, which has been the subject of several cases.<sup>59</sup> Even if, to analogize to decanting and trustee powers, the debtor/partner/member has fiduciary duties to other partner/members. Restrictions in a partnership agreement relegating the status of a

partner/member to that of an assignee to thwart the ability to seek dissolution are void as to the bankruptcy trustee pursuant to 541(c)(1)(A) quoted above.<sup>60</sup>

Borrowing from LLC defenses and bankruptcy case law, a debtor may claim that their duties as trustee are personal and akin to an executory contract and cannot so easily be assumed by the bankruptcy trustee. Generally, under §541(c)(1) quoted above, if an LLC agreement is *not* executory, both economic and noneconomic rights (management powers) attendant to the LLC interest will be property of Debtor's estate, notwithstanding dissociation provisions in the operating agreement or even state statute to the contrary (aka "ipso facto" clauses). However, some contracts involve personal services and are "executory", which brings into play 11 U.S.C. §365(c), which may trump §541 as to the non-economic interest (aka management power) and muddy the waters:

(c) The [bankruptcy] trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—

(1)

(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and

(B) such party does not consent to such assumption or assignment; or<sup>61</sup>

While trustee services *sound* personal, it would be quite a stretch to deem the trust agreement to be an executory contract. It's not like hiring Taylor Swift to sing at your daughter's birthday party – a trust agreement is not going to prohibit anyone other than the debtor/beneficiary from serving as trustee. Executory contracts are more likely to be found when someone has contractual obligations involving unique knowledge or expertise in their capacity as member/manager (think partnering with Donald Trump to develop properties or establish a university).

Other spendthrift trust cases may also be informative. Not all trust rights are protected from inclusion in the bankruptcy estate. A sole trustee/beneficiary's power to remove their own spendthrift provision may be treated as a de facto presently exercisable general power to appoint the sole trustee/beneficiary's interest, which has a strong statutory and case history of being denied exclusion, even if the power is purported to be personal to the power holder under the trust document in question, despite any spendthrift clauses.<sup>62</sup> Thus, the common beneficiary/powerholder right to withdraw the greater of \$5,000 or 5% of trust corpus jeopardizes that portion of the trust and empowers the bankruptcy trustee to exercise a withdrawal power over that amount of the trust. If a beneficiary/powerholder has a right to withdraw 50% at age 35 and files bankruptcy after attaining that age, then the bankruptcy trustee obtains this right over 50% is part of the bankruptcy estate, despite §541(c)(2) and any spendthrift clause.<sup>63</sup> This should be similar for full terminations.<sup>64</sup>

The *Neuton* case cited above and the many cases following it also lead us to a more likely conclusion to the "chicken and egg" debate and whether  $\S541(c)(2)$  can exclude a trust before any other avenue for attack can penetrate. In *Neuton*, the debtor/beneficiary of a third party spendthrift trust argued that the trust was excluded per \$541(c)(2). However, the bankruptcy trustee successfully argued that California law,<sup>65</sup> which permitted a judgment creditor to access up to 25% of a spendthrift beneficiary debtor's distributions *upon petition* (NOT automatically – spendthrift clauses still prohibited assignment or alienation absent petition), allowed the bankruptcy trustee the same power as such a creditor pursuant to \$544, thus reducing the spendthrift exclusion under \$541(c)(2) accordingly. The court did not require the bankruptcy trustee to take the additional step to file a petition first before finding the trust to be included, but remanded for finding of how much of the 25% was necessary for the debtor and his dependent's support.

While estate planners certainly do not see the above mentioned powers taken together as a presently exercisable general power of appointment, a creditor attorney or bankruptcy trustee certainly would. With such uncertainty, it's anyone's guess how the many different courts may interpret these issues when creditors clue into what rights and powers a sole trustee/beneficiary (or one who can become one) truly has. If we step back and look at the equities and public policy as any aid to interpretation, it's hard to imagine any sympathy for the debtor.<sup>66</sup>

# Effect if a Debtor's Trust Interest Becomes Part of a His or Her Bankruptcy Estate

If a debtor's trust interest becomes part of the bankruptcy estate, it would rarely mean an instant garnishment of all the assets – the bankruptcy trustee would merely step into the shoes of the debtor's interest. Let's take a simple common example of a \$2 million bypass trust with widow Jane as a lifetime beneficiary (all net income, plus principal for HEMS), with her son John as remainder beneficiary to take outright at her death. In scenario #1, Jane is sole trustee, in scenario #2, John is sole trustee.

Scenario #1: Jane files bankruptcy, seeking to exclude her lifetime interest in the bypass trust. If the bankruptcy trustee is successful in arguing that Jane can remove her own spendthrift clause (therefore making it ineffective), the income interest would be attachable, similar to the *Delmoe* case cited above, but not necessarily the principal. How a creditor would practically access her discretionary access for health, education and support is more complicated and may depend on circumstances and the state court in question.<sup>67</sup>

Scenario #2: John files bankruptcy, seeking to exclude his remainder interest in the bypass trust. If the bankruptcy trustee is successful in making the above argument, the remainder interest is attachable. If John is healthy and his mother is on her deathbed, this interest is worth quite a bit. If John predeceases his mother, the interest is worthless, since John's interest is likely contingent on his surviving his mother. Jane's interest would remain untouched, however, and John could continue to make reasonable distributions of income and principal to her under the trust's distribution standards. If Jane had a testamentary power of appointment, she could appoint her interest at her death to thwart John's creditors.

# Effect of Being a Sole Trustee/Beneficiary on Tax Liens and Tax Lien Priority

Creditors may have to get in line behind the IRS if the debtor/beneficiary has a tax lien, which would not be uncommon. Generally, a tax lien can attach to any property interest, even a spendthrift trust.<sup>68</sup> Whether and to what extent tax liens attach to a discretionary interest and how these are categorized is still a matter of some confusion and dispute, but it is clear that federal courts regard a beneficiary being a sole trustee as a

damning factor in deciding whether a tax lien would apply.<sup>69</sup> If tax liens are a concern, there are ways to draft effective forfeiture clauses in trusts to effectively remove a debtor/beneficiary's interest prior to a tax lien attaching.<sup>70</sup>

### Solutions

Thankfully, the solution to avoiding most of the questions brought up by this article is quite simple: add a sentence or two to the trust to prohibit a sole beneficiary/trustee from unilaterally removing their own spendthrift restriction or terminating the trust, directly or indirectly, via decanting, nonjudicial settlement agreement, consolidation or otherwise, and prohibiting an uneconomical termination, without permission of at least one other beneficiary. These should be effective even if the trustee changes the situs of administration or applicable law of the trust to a broad decanting state. Conservative practitioners may also want similar prohibitions against the ability to easily remove mandatory distributions necessary to comply with see-through trust (designated beneficiary of retirement plan) rules, protections for which are often absent from decanting statutes.

Practitioners could work through their bar to lobby to change their laws in this area, of course, even to the extent of adding third party trusts to their exemption statute, but this could take years and open up a can of worms – after all, is there really any public policy rationale to protect beneficiaries of spendthrift trusts who have such de facto control over the assets?

The optimal solution of course is not to use a sole trustee/beneficiary structure at all if protection is important. Naming a co-trustee is substantially more secure, though it still has some risk, especially if the co-trustee exhibits little knowledge and control or is later simply removed!<sup>71</sup> If protection really matters, use an independent trustee or corporate trustee or co-trustee. Courts will note the meaningful difference, even if the debtor/beneficiary has the right to fire and replace the corporate trustee.<sup>72</sup>

And, while this is not a focus of the paper, don't mandate a reasonable trustee fee for a trustee/beneficiary if they are entitled to current distributions! This is surprisingly common, yet merely invites the IRS to impute taxable income under constructive receipt rules (unless the right is waived in writing within a reasonable time), especially "when the

waiver is intended to benefit the beneficiaries". Furthermore, it may impute a taxable gift to the beneficiaries and/or muddy the waters with discharge of indebtedness income when fees are later waived.<sup>73</sup> A better practice would be to state that a current beneficiary serves without fee unless a reasonable fee is later agreed to between current and remainder beneficiaries.

More important for this newsletter, it invites any creditor or bankruptcy trustee with an ounce of knowledge about trusts to make several devastating arguments, that: 1) the debtor/trustee is entitled to current trustee fee, which is part of the bankruptcy estate; 2) the debtor/trustee is entitled to retroactive trustee fees, at least back as far as any statute of limitations, which are part of the bankruptcy estate; and/or 3) that the waived fees that are *not* recoverable are a de facto contribution to the trust, either still voidable under fraudulent transfer laws and/or making the trust in part self-settled as to the percentage of the trust corpus allocable to the waived fees.

#### **False Solutions**

One is tempted to simply say, well, if my client gets in trouble with creditors, they can simply resign as trustee, or appoint an independent co-trustee. This may not be enough to cut the mustard for several reasons: 1) there may be a retained power to simply regain the same sole power later; 2) the damage of deemed general powers/dominion and control may already be done by that point and, perhaps most importantly; 3) it may be considered to be a fraudulent transfer (voidable transaction) because it was arguably done to hinder, delay or defraud creditors, who could either reverse and avoid the action or even disqualify a debtor from bankruptcy discharge.<sup>74</sup>

Another potential solution may be to adapt a cessor/forfeiture provision that is often contained in more robust spendthrift clauses to remove mandatory distributions (including those for health, education and support), and apply it instead to any sole trustee/beneficiary powers mentioned above (e.g. convert "shall" to "may in sole discretion", or add new current beneficiaries). While this may avoid a fraudulent transfer claim, the efficacy of such clauses in this vein is still uncertain. Better to simply avoid overly robust sole trustee/beneficiary powers in the first place – it hardly damages the flexibility of a trust to have such actions

approved by another beneficiary or trustee. Indeed, it's probably a very minor restriction a settlor would welcome.

# HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!



### **TECHNICAL EDITOR: DUNCAN OSBORNE**

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### **CITATIONS:**

<sup>2</sup> Estate tax inclusion for a third party created trust could implicate IRC §2041. If a trustee-beneficiary has unlimited discretion to distribute to themselves, without any ascertainable standards, it would be taxable as a general power of appointment. Treas. Reg. §20.2041-1(c)(2). This would also be true if the beneficiary could remove the current trustee and name themselves as trustee without any applicable ascertainable standards. From Treas. Reg. §20.2041-1(b)(1): "A power in a donee to remove or

<sup>&</sup>lt;sup>1</sup> Every asset protection article seems to recommend an independent trustee as ideal, but few explore why in detail, leaving many practitioners left to look at their state statutes and perhaps falsely conclude that every spendthrift trust, even beneficiary-trusteed, is equally protected from all but exception creditors.

discharge a trustee and appoint himself may be a power of appointment. For example, if under the terms of a trust instrument, the trustee or his successor has the power to appoint the principal of the trust for the benefit of individuals including himself, and the decedent has the unrestricted power to remove or discharge the trustee at any time and appoint any other person including himself, the decedent is considered as having a power of appointment." Broad discretion in an independent trustee would not cause inclusion in a beneficiary's estate even if the corpus could be exhausted for their benefit. Rev. Rul. 76-368. Trusts with a beneficiary/trustee should also avoid powers to distribute to those whom a beneficiary/trustee has a duty to support. Of course, the above assumes that estate inclusion is a bad thing – for the vast majority of the population, it is rather the opposite, see extensive discussion how to affirmatively and selectively cause or avoid estate inclusion for optimal income tax results in the white paper The Optimal Basis Increase Trust available at

<u>https://papers.ssrn.com/sol3/papers.cfm?abstract\_id=2436964</u>. State law savings clauses often limit a beneficiary/trustee's distributions to themselves to ascertainable standards unless the document specifically overrides it. See, e.g., Uniform Trust Code §814(b).

<sup>3</sup> Uniform Trust Code §501.

<sup>4</sup> Restatement 3d of Trusts, § 56.

<sup>5</sup> *In re Delmoe*, 365 BR 124 (S.D. Ohio 2007).

<sup>6</sup> Warren v. Sec. Nat'l Bank (In re Oelrich), 2007 Bankr. LEXIS 2961 (B.A.P. 6th Cir. Sept. 11, 2007).

<sup>7</sup> *Kohut v. Lewiston Living Trust (In re Lewiston)*, 532 B.R. 36 (Bankr. E.D. Mich. 2015). That a revocable trust is in the settlor's bankruptcy estate is no surprise – what makes the case more unique, and is also a great argument against using joint revocable trusts – the wife allegedly put \$1.5 million of her own assets into the trust, but the court found 100% of the trust to be part of the husband/debtor's bankruptcy estate regardless! Had the wife put \$1.5 million into *her own* revocable living trust, with husband as co-trustee and beneficiary, the assets would likely have remained protected. In *Pandy v. Indep. Bank*, 2016 CO 49, 372 P.3d 1047 (Colo. 2016), a creditor was able to foreclose upon the entire property of a joint revocable living trust despite the fact that the judgment/debt was only

against the husband/settlor, not the wife/settlor - had two trusts been used, it seems likely that half the property would have been protected from foreclosure. It was unclear from the case how much the non-debtor spouse contributed. In Estes v. Crowley, 2011 Conn. Super. LEXIS 2801 (Conn. Super. Ct. Oct. 26, 2011), the debtor and his wife established a joint living trust but the court disallowed any exemption from garnishment. It's no surprise that a court would disallow a self-settled revocable trust any spendthrift protection from garnishment, but it allowed the debtor to garnish the entire trust, with absolutely no discussion of protecting any portion that the non-debtor wife may have contributed or been entitled to. One might attempt to distinguish these cases and just conclude they're the result of ineffective counsel, but, at a bare minimum, joint revocable trusts create ambiguity for creditors to exploit and an evidentiary and procedural hurdle for married couples to overcome when only one spouse is a debtor. If spouses file tax returns married filing separately, joint trusts also complicate accounting and force a Form 1041 tax filing that can ordinarily be avoided with revocable trusts. Treas. Reg. §1.671-4(b)(8).

<sup>8</sup> E.g. selling a remainder interest in a grantor retained annuity trust (GRAT) to a GST-exempt trust or selling a lead interest in a charitable remainder trust (CRT).

<sup>9</sup> See, e.g. Restat. 3d Trusts, §57-60, especially §58 (the "Chapter 12" exceptions discussed in §56 quoted above), 11 USC §541(c)(2). There are a handful of outlier minority cases (wrongly decided in this author's opinion) that other courts have failed to follow, that bust third party created spendthrift trusts (find they are included as part of bankruptcy estate) without any extraneous argument: O'Neil v. Fleet Nat'l Bank (In re Britton), 300 B.R. 155 (Bankr. D. Conn. 2003), In re Crandall, 173 B.R. 836 (Bankr. D. Conn. 1994) (which strangely did not even discuss §541(c)(2) and spendthrift trusts), Janvier v. Sledge (In re Sledge), 2015 Bankr. LEXIS 1997 (Bankr. E.D.N.C. June 19, 2015) (case refused to reopen/overturn earlier decision to include a remainder interest in Kentucky spendthrift trust in a debtor beneficiary's bankruptcy estate). Some cases that bust third party trusts don't even discuss if the trust contains a spendthrift clause and you wonder if debtors just had incompetent counsel. E.g., Walsh v. Bracken (In re Davitch), 336 B.R. 241 (Bankr. W.D. Pa. 2006). These outliers show that the quality of advocacy matters and that bankruptcy

courts may not understand trust law well and may lean towards creditors even with contrary law at hand.

<sup>10</sup> Patterson v. Shumate, 112 S.Ct. 2242 (1992).

<sup>11</sup> *In re Neuton*, 922 F.2d 1379 (9th Cir. 1990), discussing Cal Prob Code § 15306.5. see also NY CLS CPLR § 5205(d).

<sup>12</sup> Green v. Zukerkorn (In re Zukerkorn), 484 B.R. 182 (B.A.P. 9th Cir. 2012) aff'd at 591 Fed. Appx. 631 (9th Cir. 2015) - read the dissenting opinion as well, the rationale for the court's decision to apply the stated law (Hawaii) for the trust is not exactly compelling or convincing, since the case, venue, trustee, debtor and beneficiaries were in California. However, the 9<sup>th</sup> Circuit affirmed in a sparse and unconsidered opinion, which may be useless for any persuasiveness outside of the 9<sup>th</sup> Circuit, but if beneficiaries live in the 9<sup>th</sup> Circuit, it's a compelling reason to avoid from the outset or move the situs of any California irrevocable trust to anywhere outside of California, as if the California income tax on trusts did not already give a strong enough reason to avoid California trustees like the plague. Arguably, cases like Huber and Zukerkorn should not be citing §270 of the Restatement of Conflict of laws for analysis, which pertains to a trust's validity, but §273, which speaks to the effect of a spendthrift clause -"whether the interest of a beneficiary of an [inter vivos] trust of movables is assignable by him and can be reached by his creditors is determined ... by the local law of the state, if any, in which the settlor has manifested an intention that the trust is to be administered, and otherwise by the local law of the state to which the administration of the trust is most substantially related." Restatement (Second) of Conflict of Laws § 273. State law doesn't have to follow a restatement, but if that's the case, courts should at least be honest about it.

<sup>13</sup> See Uniform Trust Code §503 for typical exceptions.

<sup>14</sup> See, e.g., *Bucy v. Evans (In re Evans)*, 88 B.R. 813 (Bankr. M.D. Tenn. 1988), *In re White*, No. 09-13663-NVA, 2010 Bankr. LEXIS 3505, 2010 WL 3927485 (Bankr. D. Md. Sept. 30, 2010); *Garrett v. Finley (In re Finley)*, 286 B.R. 163 (Bankr. W.D. Wash. 2002); *In re Cypert*, 68 B.R. 449 (Bankr. N.D. Tex. 1987) – there are other cases cited therein.

<sup>15</sup> *Mukamal v. Citibank N.A. (In re Kipnis)*, 555 B.R. 877 (Bankr. S.D. Fla. 2016) cites five prior district level cases consistent with its holding that the 10 year statute of limitations applied to fraudulent transfer actions in bankruptcy when the IRS is a creditor, and rejects the one district level case holding to the contrary (that state law statutes of limitation still applied in bankruptcy, not the federal statute). In this author's opinion, *Kipnis* and the five cases it followed are correct. There is no appellate level case on this issue. While not discussed in *Kipnis* (nor its predecessor cases), this exception may also apply if *state* taxes are owed, since a state may also extend its ordinary statute of limitations for *state* tax collections.

<sup>16</sup> 11 U.S.C. §548(e).

<sup>17</sup> NY CLS EPTL § 7-1.5 "(a) The interest of the beneficiary of any trust may be assigned or otherwise transferred, except that:

(1) The right of a beneficiary of an express trust to receive the income from property and apply it to the use of or pay it to any person may not be transferred by assignment or otherwise unless a power to transfer such right, or any part thereof, is conferred upon such beneficiary by the instrument creating or declaring the trust."

<sup>18</sup> Uniform Trust Code § 502(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.

<sup>19</sup> See, e.g. Ohio R.C. §5805.04(F), Uniform Trust Code §504(e), *Birdsell v. Coumbe (In re Coumbe)*, 304 B.R. 378 (B.A.P. 9th Cir. 2003)

<sup>20</sup> For a recent example of such a case see *Chantel v. Pierce (In re Chantel)*, 2015 Bankr. LEXIS 2174 (B.A.P. 9th Cir. July 1, 2015), busting a trust on an alter ego theory, which is similar to self-settled trust busting. In *Chantel*, the debtor got a straw person to execute and establish a trust with the debtor, and later his wife, as co-trustee and beneficiaries. Debtor and wife *funded 100%* of the trust, and used it for personal expenditures. The bankruptcy court ignored the trust, denied exclusion, and denied discharge to the debtor for hiding the assets.

<sup>21</sup> In re Baldwin (Scott v. Bank One Trust Co.), 142 BR 210, 214 (S.D. OH 1992), citing several cases.

<sup>22</sup> *Diamond v. Trawick (In re Trawick)*, 497 B.R. 572 (Bankr. C.D. Cal. 2013), upholding spendthrift protection (analyzing N.C. law) where trustee was one of several beneficiaries of third party created spendthrift trust.

<sup>23</sup> In re McCollough (Richardson v. McCollough), 259 BR 509 (Bankr. D.R.I. 2001).

<sup>24</sup> In re Schwen (Schwen v. Ramette), 240 BR 754 (Bankr. Minn. 1999).

<sup>25</sup> In re Pugh, 274 BR 883, 887 (Bankr. D. Ariz 2002).

<sup>26</sup> Johnson v. McCoy (In re McCoy), 274 B.R. 751 (Bankr. N.D. III. 2002), aff'd McCoy v. Johnson (In re McCoy), 2002 U.S. Dist. LEXIS 13239 (N.D. III. July 19, 2002).

<sup>27</sup> Atkinson v. Commissioner, 309 F.3d 129 (11th Cir. 2002).

<sup>28</sup> Rosen v. Heifner (In re Heifner), 2012 Bankr. LEXIS 3032 (Bankr. N.D. Ohio July 3, 2012).

<sup>29</sup> *In re Scott*, 2007 Bankr. LEXIS 2733 (Bankr. S.D. Fla. Aug. 8, 2007). Florida court interpreting Texas law.

<sup>30</sup> See Restatement (Second) of Prop.: Donative Transfers §§ 11.1 cmt. a, 19.3 cmt. a, illus. 1, 19.4 (1986); Restatement (Third) of Prop.: Wills & Other Donative Transfers § 19.14.

<sup>31</sup> Most readers have seen something like these sentence in trusts: "The Trustee's power to pay income or principal to a trust beneficiary shall include the power to apply the same for the benefit of the beneficiary, or to pay in further trust for the benefit of the beneficiary."; "The trustee may apply principal or income for the benefit of any beneficiary by payment to such person or persons (including, without limitation, other estates or trusts, individuals and institutions) as the trustee, in the exercise of sole and absolute discretion, may determine (including any such trust was created pursuant to authority granted to the trustee hereunder or otherwise); "Any application of principal or income for the benefit of any beneficiary hereunder made pursuant to the provisions of this agreement may include payment to trusts for such beneficiaries." These kind of clauses should be clear to avoid any implication that they enable avoidance of payment of income necessary to qualify for QSST, QTIP, conduit trusts

or other benefits. Many decanting statutes address marital, charitable and QSST trusts with a savings clause to avoid such interference, but do nothing to protect see through trust qualification as a "designated beneficiary" of IRA/qualified plan benefits, even though arguably they threaten a conduit trust or the certain outright eventual vesting needed for an accumulation trust. See discussion of this in separate IRA CLE material by author.

<sup>32</sup> For a short list of decanting statutes and citations and dates of enactment, see Ohio attorney Patty Culler's list at http://www.actec.org/assets/1/6/Culler-Decanting-Statutes-Passed-or-<u>Proposed.pdf</u> and for a more detail, see Susan Bart's compiled summaries at http://www.sidley.com/en/experience/state-decanting-statutes. For an example of some of the few that prohibit a beneficiary/trustee from unilaterally amending/decanting their own trust, see N.Y. Est. Powers & Trusts § 10-6.6(s)(2): "The term "authorized trustee" means, as to an invaded trust, any trustee or trustees with authority to pay trust principal to or for one or more current beneficiaries other than (i) the creator, or (ii) a beneficiary to whom income or principal must be paid currently or in the future, or who is or will become eligible to receive a distribution of income or principal in the discretion of the trustee (other than by the exercise of a power of appointment held in a non-fiduciary capacity)"; N.C. Gen. Stat. § 36C-8-816.1(d): "A trustee may not exercise the power to appoint principal or income under subsection (b) of this section if the trustee is a beneficiary of the original trust, but the remaining cotrustee or a majority of the remaining cotrustees may act for the trust. If all the trustees are beneficiaries of the original trust, then the court may appoint a special fiduciary with authority to exercise the power to appoint principal or income under subsection (b) of this section." S.C.

§ 62-7-816A: "(e) A trustee may not exercise the power to appoint principal or income under subsection (a) of this section if the trustee is a beneficiary of the original trust, but the remaining cotrustee or a majority of the remaining cotrustees may act for the trust. If all the trustees are beneficiaries of the original trust, then the court may appoint a special fiduciary with authority to exercise the power to appoint principal or income under subsection (a) of this section."; Va. Code Ann. § 64.2-778.1(D): "A trustee who is an interested trustee may not exercise the power to appoint under this section. The remaining cotrustee or a majority of the remaining

cotrustees who are not interested trustees may exercise the power under this section. If all the trustees are interested trustees, or at the request of any of the trustees, the court may appoint a special fiduciary with authority to exercise the power under this section."

 $^{33}$  AS § 13.36.158(h), C.R.S. §15-16-915(3), 760 ILCS 5/16.4(m), Ind. Code § 30-4-3-36(e), Ky. Rev. Stat. Ann. § 386.175(6)(c), Minn. Stat. § 502.851(14), Mo. Rev. Stat. § 456.4-419(2)(7), Nev. Rev. Stat. § 163.556(14), N.H. Rev. Stat. Ann. § 564-B:4-418(I)(3), N.H. Rev. Stat. Ann. § 564-B:4-419(g)(3), N.M. Stat. § 1-115(C), N.Y. Est. Powers & Trusts § 10-6.6(m), Ohio R. C. § 5808.18(H), R.I. Gen. Laws § 18-4-31(f), S.C. § 62-7-816A(f)(3), S.D. Codified Laws §§ 55-2-15(8) Tenn. Code Ann. § 35-15-816(b)(27), Texas Prop. Code § 112.084, Va. Code Ann. § 64.2-778.1(E)(4), Wisc. Stat. § 701.0418(8)(b) (Wisconsin's statute is one of the exceptions to specifically state that spendthrift clauses can either be added or removed through decanting, at § 701.0418(4)(a)(7). In addition to the above states, also see the Uniform Trust Decanting Act §15(c).

<sup>34</sup> Indeed, while it seems counterintuitive, one of the earliest cases reported under a state decanting statute involved the trustee's removal, which the court approved, of spendthrift clauses in the trust to enable beneficiaries' interests to be assigned. *In re Kaskel*, 163 Misc. 2d 203 (N.Y. Sur. Ct. 1994).

<sup>35</sup> Uniform Trust Decanting Act is relatively recent, as of January 2017, only passed in Colorado and New Mexico: <u>www.uniformlaws.org</u>. See comments under §11 (broad power decanting) – it very specifically allows adding *or removing* a spendthrift provision. While this is not specifically mentioned in §12 (limited power decanting), the biggest limitation of §12 limited power decanting is that such decanting "in the aggregate, must grant each beneficiary of the first trust beneficial interests which are substantially similar to the beneficial interests of the beneficiary in the first trust." It's hard to see how such a change by itself would not come under this standard – if anything the beneficiary to decant.

<sup>36</sup> From comments to Uniform Decanting Act § 19, which contains several tax savings provisions for marital trusts, QSSTs, see through trusts, etc: "Catch-all. Subsection (b)(8) is a catch-all provision intended to preserve any tax benefits not specifically listed in Section 19 for which the first trust

qualified if the first-trust instrument expressly indicates an intent to qualify for the tax benefit or is clearly designed to qualify for the tax benefit. Note that subsection (b)(8) does not address any tax benefits for which the trust may qualify in the future. For example, assume that the first trust was a credit shelter trust that was not subject to federal estate tax at the death of the first to die of a married couple because of the decedent's federal exclusion. Assume that an independent person may make discretionary distributions to the surviving spouse and descendants pursuant to expanded discretion. Also assume that the credit shelter trust was designed so that it would not be included in the surviving spouse's estate. The authorized fiduciary could decant and the second trust could grant the surviving spouse a general power of appointment that would cause inclusion in the surviving spouse's estate. Although the credit shelter trust was designed to be excluded from the surviving spouse's estate, such tax benefit is one that would occur, if at all, in the future at the surviving spouse's death; it is not a tax benefit claimed in the past. Therefore subsection (b)(8) does not prohibit such a modification. If the settlor's purposes include saving taxes, and causing inclusion in the spouse's estate may save more taxes by causing a basis adjustment at the surviving spouse's death even though the trust assets would then be included in the surviving spouse's estate, then such a decanting may be appropriate and is not prohibited by subsection (b)(8)." Taking this paragraph, combined with the more specific example in §11 permitting the removal of a spendthrift provision, indicates that a tax savings clause is unlikely to be seen as prohibiting the removal of a spendthrift clause.

<sup>37</sup> Uniform Trust Code §107 permits governing law to be "the jurisdiction designated in the terms unless the designation of that jurisdiction's law is contrary to a strong public policy of the jurisdiction having the most significant relationship to the matter at issue;"

<sup>38</sup> E.g. Ohio R.C. §5808.18 (O)(2) "Division (B) of this section applies to distributions made on or after March 22, 2012, from any trust that is governed by the law of this state **or that has its principal place of administration in this state**, whether that trust was created before, on, or after March 22, 2012." Similarly, §5(1) of the Uniform Decanting Act and other states have similar provisions. Some states pride themselves in being ranked as having the broadest decanting statute, permitting removal of mandatory interests and ascertainable standards, adding beneficiaries

and the like. Whether this may someday have a negative blowback for tax or asset protection or due process purposes remains to be seen. About seven states do not even require notice to other beneficiaries of the decanting: SD, NV, TN, NH, DE, WY, AZ.

<sup>39</sup> Uniform Trust Code §417, Similar is Ohio R.C. §5804.17, Utah §75-7-417

<sup>40</sup> Uniform Trust Code §417(c), Ohio R.C. §5804.11(B)

<sup>41</sup> Uniform Trust Code §416 (Modification to Achieve Settlor's Tax Objectives) "not contrary to *settlor's probable intention*", §415 (Reformation to Correct Mistakes) "to conform the terms to the *settlor's intention*", §412 (Modification or Termination Because of Unanticipated Circumstances) "in accordance with the *settlor's intention*", §411 (Modification or Termination of Noncharitable Irrevocable Trust by Consent).

<sup>42</sup> Uniform Trust Code §414 – states often vary the particular dollar threshold. Ohio, for instance, increased the amount to \$100,000 at Ohio R.C. §5804.14 (Ohio has a more robust and in this author's opinion better thought out version of UTC §414, but it still has the same principal issue as the UTC provision that is the subject of this article and the same language permitting a beneficiary/trustee to disregard the spendthrift clause) – Most states are higher than the \$50,000 in the original UTC, e.g., Utah §75-7-414 (\$100,000), Nebraska (\$100,000), Massachusetts (\$200,000), Kansas §58a-414 (\$100,000), South Dakota SDCL §55-3-27 (\$150,000). Some states are silent as to the amount that is "uneconomical": 20 Pa. CS § 7740.4 There could be states with higher minimums, I only surveyed a handful of states. Some state uneconomical termination statutes require court approval, e.g., New York EPTL § 7-1.19.

<sup>43</sup> Uniform Trust Code §414, comments.

<sup>44</sup> Strangely, these provisions are not in the same section of the code as the other modification and termination provisions, but in the definition section – see e.g., Uniform Trust Code §111, Ohio R.C. § 5801.10, 20 Pa. C.S. § 7710.1(d)(11).

<sup>45</sup> See compilation of state statutes and features at <u>http://www.actec.org/assets/1/6/Bart-Virtual-Representation-Statutes-</u> <u>Chart.pdf</u>. Ohio has amended its virtual representation statute since this chart was last updated to add the ability of a holder of a testamentary *limited* power of appointment to virtually represent potential appointees. H.B. 432, passed January 4, 2017, effective 90 days after, which will amend Ohio R.C. §5803.02.

<sup>46</sup> It may surprise people that a court and the IRS would approve adding the settlors as discretionary beneficiaries of an irrevocable grantor trust, even if capped at income tax liability attributable to them via grantor trust rules. See recent PLR 2016-47001, where this was accomplished without adverse tax effect, albeit this power to pay/reimburse was restricted to nonsubordinate/related trustees. See Rev. Rul. 2004-64, holding that such discretionary powers do not by themselves cause estate inclusion, absent preunderstanding, prearrangement, ability of settlor to remove and become trustee, or such a provision causing creditor access to the trust. Presumably the taxpayer and their counsel in this PLR were availing themselves of a state law that would still protect settlors from creditors if such a trustee ability to reimburse or pay a settlor's taxes were added (such as Ohio R.C.§5805.06(B)(3)(c), or any number of state DAPT statutes). On a related side note, many trust reimbursement clauses and state statutes are silent about accumulations – if the trustee fails to reimburse income tax attributable for 10 years, may a trustee in year 11 then pay 10 years back income tax attributable? Plus interest? Is this protected by Rev. Rul. 2004-64 safe harbor? Could this much larger accumulation then deem more of the trust to be self-settled for §548(e) or other purposes?

<sup>47</sup> E.g., Ohio R.C. §5808.18(L)(2).

<sup>48</sup> 11 U.S.C. §548(e) – for two self-settled irrevocable trusts pierced under this theory, see *In re Huber*, 2013 Bankr. LEXIS 2038 (Bankr. W.D. Wash. 2013) and *Battley v. Mortensen (In Re Mortensen)*, Adv. D.Alaska, No. A09-90036-DMD, May 26, 2011.

<sup>49</sup> It is easy to confuse and conflate exclusions and exemptions under the bankruptcy code, which are found at 11 U.S.C. §541 and 11 U.S.C. §522 respectively. When we think of state statutes opting to exempt IRAs or even inherited IRAs, unlimited homesteads, life insurance and similar categories, this is usually implicating §522 (although if there is a trust or quasi trust such as an IRA, it may implicate both). If a state added third party trusts to this category of asset, with or without a spendthrift clause,

then conceivably trusts could be protected under the umbrella of §522 – this is essentially what states are doing when they add protections for Health Savings Accounts, 529 plans and the like. But states do not directly create exclusions.

<sup>50</sup> 11 U.S.C. §541.

<sup>51</sup> Askanase v. LivingWell, Inc., 45 F.3d 103 (5th Cir. Tex. 1995), also cited in *Cutter v. Seror (In re Cutter)*, 398 B.R. 6, 19 (B.A.P. 9th Cir. 2008).

<sup>52</sup> In re Gifford, 93 B.R. 636, 640 (Bankr. N.D. Ind. 1988).

<sup>53</sup> West v. Parker (In re Watson), 325 B.R. 380 (Bankr. S.D. Tex. 2005) – in this case, the court even awarded 40% attorney fee to the bankruptcy trustee for the Crummey trust trustee's failure to comply with the bankruptcy trustee's demand to exercise the debtor/beneficiary's hanging withdrawal power. In previous CLEs and presentations, I have argued that the portion of the withdrawal power that is hanging can be the subject of a forfeiture or cessor clause or trustee/trust protector removal provision that could eliminates the power should any creditors of the *Crummey* beneficiary arise - this lapse may then cause a taxable gift to be deemed to the debtor/power holder, but having a few dollars of \$5.49 million applicable exclusion amount used up is by far a much better result than having it garnished with additional attorney fees to be paid to boot! Cessation of the "hang" would not impact whether there was a present interest at the time of the gift. In addition, the settlor or trustee/protector could have the ability to modify whether a particular beneficiary has withdrawal rights over future contributions without tainting prior gifts or the trust nor implicating any fraudulent transfer laws.

<sup>54</sup> Osherow v. Porras (In re Porras), 224 B.R. 367 (Bankr. W.D. Tex. 1998).

<sup>55</sup> In re Langley, 30 B.R. 595, 600 (Bankr. N.D. Ind. 1983).

<sup>56</sup> Though bankruptcy need not follow tax law precisely, see IRC §2041 and §2514 and their regulations for discussion of general powers of appointment for tax law purposes.

<sup>57</sup> *Thompson v Texas M. R. Co.,* 328 US 134, 90 L Ed 1132, 66 S Ct 937 (1946).

<sup>58</sup> United States ex rel. Gebert v. Transp. Admin. Servs., 260 F.3d 909 (8th Cir. Mo. 2001).

<sup>59</sup> Cardiello v. United States, IRS (In re Garbinski), 465 B.R. 423 (Bankr. W.D. Pa. 2012). Although a bankruptcy court may still honor state law requiring the bankruptcy trustee to petition a state of incorporation's courts to dissolve an entity – in this particular case, Nevada: *Montana v. Blixseth* (*In re Blixseth*), 484 B.R. 360 (B.A.P. 9th Cir. 2012).

<sup>60</sup> Samson v. Prokopf, 185 B.R. 285 (Bankr. S.D. III. 1995).

<sup>61</sup> 11 U.S.C. §365(c)

<sup>62</sup> See Casey v. Schneider (In re Behan), 506 B.R. 8, 16 (Bankr. D. Mass. 2014), and general rule in the Restatement of Property, 2<sup>nd</sup>, Donative Transfers §13.6. This rule is true even if the power does not sound like the usual general power of appointment language, such as "as she directs". See e.g., *In re Salahi*, 2012 Bankr. LEXIS 1813 (Bankr. E.D. Va. Apr. 24, 2012)

<sup>63</sup> *Hoff v. McConnell (In re Hoff)*, 644 F.3d 244 (5th Cir. Tex. 2011). See also, *In re Newman*, 903 F.2d 1150 (7th Cir. III. 1990), protecting and excluding a trust that would terminate at age 50 for a 45-year old debtor, but noting protection would be non-existent had debtor filed bankruptcy at age 50.

<sup>64</sup> A typical case would be *Lunkes v. Gecker*, 427 B.R. 425 (N.D. III. 2010), which denied protection for a third party created spendthrift trust that was ripe for a terminating distribution, but there is some contrary (and debatable) case law if the trust contains a cessor clause, see *Safanda v. Castellano*, 2015 U.S. Dist. LEXIS 54458 (N.D. III. Apr. 27, 2015) and several articles discussing it and underlying reversed case: LISI Asset Protection Newsletters #258 Jay Adkisson, David Slenn & Philip Martino on *In re Castellano: A Wake-Up Call for Self-Settled Trusts and Spendthrift Provisions*, #259 Mary Vandenack & Dan Wintz: *Drafting Considerations for the Third-Party Spendthrift Trust after In re Castellano*, #270 Alexander A. Bove, Jr. on *Castellano: The Wrong Result for the Right Reasons*, #297 Jonathan E. Gopman, Ryan J. Beadle, Michael A. Sneeringer, Evan R. Kaufman and Alan S. Gassman on *Safanda v. Castellano: District Court Tells Bankruptcy Court to Cast-away-no.* It concerned a trust that was to

pay corpus outright to beneficiaries, but had a spendthrift clause with additional provisions removing the mandatory distribution triggered upon notice of any insolvency or bankruptcy. Without going into this case in depth, the first bankruptcy case decision had extremely flawed reasoning on many points, finding the debtor made a fraudulent transfer among other arguments, and denying §541(c)(2) exclusion. The federal district court reversed, bucking the general trend in this area, and held the spendthrift clause still excluded the trust from the bankruptcy estate pursuant to §541(c)(2). Despite the debtor's success and the very flawed reasoning of the underlying decision, this was still not an easy case. Because the clause was not a condition precedent to the debtor/beneficiary's vesting of rights, the debtor had the equivalent of a presently exercisable general power of appointment until the clause was triggered, and arguably became a settlor of the trust by virtue of the lapse/release of the power. This argument was not addressed by the bankruptcy or district court, which inexplicably did not address the many cases denying exclusion for portions of trust that are mandated distributions or subject to withdrawal or general power of appointment.

<sup>65</sup> Cal Prob Code § 15306.5

<sup>66</sup> The access to a spendthrift trust by a sole trustee/beneficiary is at times extremely similar to an inherited IRA, but without even the typical tax burdens to discourage taking the money out. The unanimous Supreme Court's most recent opinion in this area, noted that:

"For if an individual is allowed to exempt an inherited IRA from her bankruptcy estate, nothing about the inherited IRA's legal characteristics would prevent (or even discourage) the individual from using the entire balance of the account on a vacation home or sports car immediately after her bankruptcy proceedings are complete. Allowing that kind of exemption would convert the Bankruptcy Code's purposes of preserving debtors' ability to meet their basic needs and ensuring that they have a "fresh start," into a "free pass". *Clark v. Rameker,* 134 S. Ct. 2242 (U.S. 2014). *Rameker* would not be controlling for a sole trustee/beneficiary case - the protection comes under a different code section (§541 exclusion v. §522 exemption), which arguably has a different rationale and purpose, but the fact that the Supreme Court took a very tortured creditor-friendly interpretation of the definition of "retirement funds" should give one pause in assuming their client with the trust fund is so deserving of protection. For an article on the Rameker case, see Ed Morrow on Clark v. Rameker: Supreme Court Holds that Inherited IRAs Are Not Protected in Bankruptcy: Are Spousal Inherited IRAs and Even Rollover IRAs Threatened As Well? LISI Asset Protection Planning Newsletter #248 (June 16, 2014).

<sup>67</sup> For general discussion of this, see Restatement, 3d, Trusts, §60 Transfer or Attachment of Discretionary Interests: "Subject to the rules stated in §§ 58 and 59 (on spendthrift trusts), if the terms of a trust provide for a beneficiary to receive distributions in the trustee's discretion, a transferee or creditor of the beneficiary is entitled to receive or attach any distributions the trustee makes or is required to make in the exercise of that discretion after the trustee has knowledge of the transfer or attachment. The amounts a creditor can reach may be limited to provide for the beneficiary's needs (Comment c), or the amounts may be increased where the beneficiary either is the settlor (Comment f) or holds the discretionary power to determine his or her own distributions (Comment g)."

<sup>68</sup> *Duckett v. Enomoto*, Case No. CV-14-01771-PHX-NVW. (D. AZ, April 18, 2016). The IRS subsequently attempted to amend the judgment to expand its attachment capabilities but this was denied at *Duckett v. Enomoto*, 2016 U.S. Dist. LEXIS 73399 (D. Ariz. 2016) – the IRS was left with the awkward but still powerful ability to enforce the lien "as to the amount to which [Dr.] Enomoto's right extends, i.e., the amount the trustee's withholding of which would be an abuse of discretion in applying the trust's standard of payment. Evidence of Dr. Enomoto's overall financial situation is the sort of evidence that might show that the trustee's withholding of payment would be an abuse of discretion"; IRS C.C.A. 2000-36045.

<sup>69</sup> The *Enomoto* trust required an independent trustee. The decision compared and contrasted the case to a similar one, *United States v. Delano*, 182 F. Supp. 2d 1020 (D. Colo. 2001), in which a tax lien attached to a discretionary interest thus: "In some respects, however, Delano had greater control over the trust funds there than Dr. Enomoto does here, because Delano had the option to terminate the trust and retain all trust assets and *because he and his son were the trustees*. Id. at 1021-23. *Thus, the argument for federal tax lien attachment is weaker* here than in *Delano*." In addition to the recent *Duckett* case, see *United States v. O'Shaughnessy*, 517 N.W.2d 574 (Minn. 1994)(holding that a tax lien did not attach to a debtor's discretionary interest and testamentary limited power of appointment in trust because it did not rise to the level of a

property right under Minnesota law). The United States may attach distributions a trustee decides to make in the exercise of its discretion after the lien attaches and a trustee can be liable for paying distributions to or for the benefit of a beneficiary in face of such a lien. *U.S. v. Cohn*, 855 F. Supp. 572 (D. Conn. 1994). The law may have tilted more in the favor of the IRS after the Supreme Court's *Drye* and *Craft* decisions, and it's debatable whether future courts will refuse to find that equitable rights of a discretionary beneficiary are a property interest under federal law – what state law calls them should be completely irrelevant.

<sup>70</sup> See other asset protection material from author with sample clauses, such as Ohio State Bar Association 24th Annual Estate Planning Conference on Wealth Transfer June 13, 2013, inspired by Professor Bryan Camp's *Protecting Trust Assets from the Federal Tax Lien* (June 23, 2009), Estate Planning & Community Property Law Journal, Vol. 1, p. 295, 2009. Available at SSRN: <a href="https://srn.com/abstract=1424666">https://srn.com/abstract=1424666</a>

<sup>71</sup> For a case where a titular co-trustee was simply ignored, see *In re Pugh*, 274 BR 883, 887 (Bankr. D. Ariz 2002), where the court busted a third party irrevocable trust created by parent for son. Son and his sister were cotrustees but the sister never had any access or knowledge of what was going on in the trust, hence the court ignored her and deemed son debtor as sole trustee for himself. However, in a similar brother/sister co-trustee third party created irrevocable trust scenario without the bad administrative facts, the trust's exclusion was upheld: In re Schwen (Schwen v. Ramette), 240 BR 754 (Bankr. Minn. 1999). It's not just the clauses in the trust, but the administration that matters - tax attorneys will recall the famous Atkinson case where a perfectly executed charitable remainder trust was voided ab initio because of sloppy administration - a lesson for asset protection as well. For a case piercing a third party irrevocable trust after beneficiary/trustee/son successfully went to court to remove his sister as co-trustee, see In re Scott, 2007 Bankr. LEXIS 2733 (Bankr. S.D. Fla. Aug. 8,2007)

<sup>72</sup> E.g., where debtor/beneficiary/co-trustee replaced Bessemer Trust with PNC as co-trustee, bankruptcy trustee tried to deny spendthrift protection because she asserted dominion and control over the trustee, but the court excluded and protected the trust, noting the importance of co-trustees, and corporate ones in particular: "While the Debtor is both a beneficiary and co-trustee of the Marital Trust, unlike the beneficiaries of the Descendant

Trusts who are beneficiaries only, this is not determinative of the validity of a spendthrift trust provision. If the Marital Trust had no other cotrustees, the argument made by the Chapter 7 Trustee and the Elliott Creditors might be more meritorious. However, the Marital Trust had two other co-trustees along with the Debtor - Herbert Gerstein and Bessemer. The fact that a co-trustee is also a beneficiary, does not render a spendthrift trust invalid. \*\*\*The existence of a corporate co-trustee is distinguishable from those cases in which one co-trustee is easily influenced or pressured by another co-trustee or beneficiary that is often a family member. See e.g., In re McCullough, 259 B.R. 509 (Bankr. D. R.I. 2001)(Debtor/beneficiary had unfettered dominion and control over trust assets). Similarly, the record does not reflect any particular influence over the substitute corporate trustee, PNC." *Elliott v. Kiesewetter (In re Kiesewetter)*, 2010 Bankr. LEXIS 6333, 26-27 (Bankr. W.D. Pa. Nov. 29, 2010).

<sup>73</sup> As to imputed taxable gift by trustee when the statute of limitations passes on collection, see Rev. Rul. 81-264. As to imputed income, see Rev. Rul. 64-225, Rev. Rul. 66-167; PLR 9033034 involved both an income tax deduction and an estate tax deduction for executor's commissions and legal fees of an estate where, after a dispute with beneficiaries, some of the legal fees already paid were refunded directly to beneficiaries and unpaid executor's commissions were waived by the executor. The statute of limitations had run on the federal estate tax return, absent a showing of fraud. The ruling held that no additional federal estate tax could be assessed unless fraud was proved. Further, the executor who waived unpaid fees was not required to report those amounts as income. The estate, however, had realized income from cancellation of indebtedness. Even though the refund of legal fees was made directly to beneficiaries, the income from the refund was nevertheless estate income, was part of DNI, and passed through to beneficiaries by virtue of any distributions. Since the estate had deducted the fees, it could not then argue that the refund and waiver represented a return of capital.

<sup>74</sup> The definition of "transfer" is much broader than one would expect, and there is no need for "fraud" in the traditional sense of the word (e.g. no need for any false or misleading representation). This is in part why the Uniform Fraudulent Transfer Act's name has been changed to the Uniform Voidable Transactions Act. See <u>www.uniformlaws.org</u>. The Supreme

Court recently confirmed that a fraudulent transfer is within the meaning of "actual fraud" that can deny a bankruptcy discharge under 11 U.S.C. §523(a)(2)(A), without the need for any false representation whatsoever, which is completely separate from 11 U.S.C. §727 that can deny a discharge for fraudulent transfers made within one year of filing. *Husky Int'l Elecs., Inc. v. Ritz*, 136 S. Ct. 1581 (U.S. 2016).