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Trusts and divorce

Trusts can offer creditor protection to beneficiaries. Yet the extent of that protection can depend on various factors, including the terms of the trust, where the beneficiary lives and the nature of the action against the beneficiary. *Pfannenstiehl v. Pfannenstiehl*, a recent decision from the Appeals Court of Massachusetts dealing with the division of property in divorce, is a case in point (88 Mass. App. Ct. 121, August 27, 2015).

The facts. H and W married in early 2000. They had two children, both with special needs (one child was dyslexic and had attention-deficit disorder, and the other had Down syndrome); W was the primary homemaker and caretaker of the children. Dad, H's father, and B, H's twin brother, ran very successful for-profit colleges through several closely held corporations (H worked as an assistant bookstore manager at one of the colleges, earning $170,000 a year). In 2004, Dad created a trust to benefit his descendants – a class that would grow as more descendants were born (at the time in question, Dad had three children (including H) and eight grandchildren, or 11 descendants in all). Dad funded the trust chiefly with shares from the companies, which generated substantial income through tuition payments. B and the lawyer who had represented Dad and the companies for 30+ years were the trustees.

The trustees could make discretionary distributions of income or principal to a beneficiary, in equal or unequal shares, for a beneficiary's "comfortable support, health, maintenance, welfare and education," and could consider a beneficiary's other sources of funds in determining whether to make a distribution; distributions were income-tax free since Dad was responsible for paying the trust's income taxes (yes, this was a "defective" grantor trust). The trust had a "spendthrift" provision that was designed to preclude a beneficiary from assigning or pledging trust property, as well as shield the property from "attachment, execution, garnishment or other seizure under any legal, equitable or other process."

The trustees only made distributions to Dad's three children: from May 2009 through March 2012, H's brother and sister received varying amounts, generally monthly, totaling $1.13 million and $1.18 million, respectively; in 2008, H received a single distribution of $300,000, and from May 2009 through August 2010,

received varying amounts, generally monthly, totaling $500,000. When H filed for divorce in September 2010, he received nothing further from the trust.

Divorce proceedings – lower court. H's divorce trial lasted eight days in early 2012. The proceedings were complicated, and "intensely litigated." A key question was whether the trust was part of the "marital estate." Under Massachusetts law, the Probate and Family Court judge had considerable latitude in ascertaining that estate and its division. She concluded that the trust, which she valued at nearly $25 million, was part of the marital estate, and that H, as one of 11 possible beneficiaries, had a 1/11 interest in the trust. The judge valued the entire marital estate at $4.3 million, and allocated 60% to W and 40% to H (in the final calculation, W received $2.33 million and H received $1.97 million).

To effect the transfers to W, the judge ordered H to pay W nearly $50,000 per month for 24 months. Thanks to loans from Dad, H was able to make about five payments; when those loans ceased, H wrote to the trustees requesting distributions from the trust so that he could comply with the judgment. The trustees denied his request, and W filed a contempt proceeding: H had not paid her from January through April 2013. H was found guilty, and ordered to jail for 60 days unless he paid what was owed (over $200,000, with interest). H appealed the contempt judgment, stating that he had no "independent ability" to make the payments and therefore could not be held in contempt; he also appealed the holding the trust was part of the marital estate.

Appeals Court. The Appeals Court vacated the contempt judgment, noting that H had tried to satisfy the monthly payments by borrowing from his father, and by asking the trustees for distributions after the loans ceased. Although one could question the "genuineness of all these machinations given the bias of the two trustees and the husband's father," it was not proved by clear and convincing evidence that H "willfully and intentionally violated a clear and unequivocal order."

The Appeals Court affirmed that the trust was part of the marital estate. Some of the factors the court looked at included the following:

- The spendthrift provision was being invoked as a "subterfuge to mask the husband's income stream and thwart the division of the marital estate in the divorce."
- The cutoff of distributions to H on the eve of divorce was a "deliberate manipulation to erase a major component of the husband's annual income and to silence his interest in the trust."
- The trust's standard for distributions to beneficiaries – "comfortable support, health, maintenance, welfare and education" – was ascertainable; H's income stream was therefore not "too remote or speculative" for inclusion in the marital estate.
- H had an enforceable right to trust distributions to support his lifestyle, his interest in the trust was "vested in possession," and he was likely to receive distributions once the divorce was over.
- The 60/40 split between W and H was also appropriate, given that W was the primary homemaker and caretaker of the two children and spent "extraordinary" amounts of time addressing their needs; H's substantial income distributions from the trust for support, maintenance and welfare "were woven into the fabric of the marriage."

A ***dissenting judge*** (with whom another judge joined) said that H's interest was "too remote and speculative, too dependent on trustee discretion, and too elusive of valuation to have been included in the

marital estate for purposes of division." Here, the trust was not solely for H, but had an "open class and multiple beneficiaries, in different generations, to whom the trustees owe fiduciary duties."

In addition, the trust's ascertainable standard could not be read in isolation. The trustees had discretion regarding the amounts and timing of distributions, and could take into account a beneficiary's funds from other sources in determining whether to make a distribution; indeed, the trustees made distributions in some years, and not in others. "In short, the husband's interest in the…trust stands on different footing from a party's interest in cases where interests are more clearly fixed and certain." The fractional share methodology used by the judge in the lower court produced an "arbitrary result." Although the majority of the court noted what it considered "machinations" on the part of the trustees to discontinue payments to H on the eve of his divorce filing so as to paint his interest as "remote and speculative where it never had been previously…the primary focus…should be the terms of the trust instrument itself, not how those terms may be or have been manipulated. In other words, consideration of such manipulation must be secondary to the terms of the trust instrument itself."

Comments. H has appealed to the Supreme Judicial Court of Massachusetts (the highest court in the state). In the meantime, what to make of this case? Several thoughts come to mind. First, in the words of the majority opinion, Massachusetts divorce law takes an "expansive view" of the "marital estate," which can include a beneficial interest in trust; in determining that marital estate and its division, a judge is allowed to weigh many factors, including "the length of the marriage, the conduct of the parties during the marriage, the age, health, station, occupation, amount and sources of income, vocational skills, employability…and needs of each of the parties." Other jurisdictions, however, may have less expansive views. Accordingly, the divorce law to which the beneficiary is subject (typically, where the beneficiary lives) will affect which of the beneficiary's property interests are "available" for purposes of dividing the marital estate – notwithstanding language in the trust that attempts to limit a creditor's access to the trust property.

Second, because the trust had an ascertainable standard for distributions ("comfortable support, health, maintenance, welfare and education"), the trust property was more accessible than it would have been if the trustees had "full discretion" for distributions, and no ascertainable standard. In this case, however, full discretion would have been problematic since H's brother was a trustee/beneficiary: for him to be able to participate in decisions regarding trust distributions *and* avoid adverse tax consequences (such as the trust property being includible in his estate), the ascertainable standard was necessary. (Note that when family members are trustees and beneficiaries, there are often trade-offs in terms of the flexibility – and potential creditor protection – the trust can provide; as with so much in the planning area, it is a balancing act.)

Third, it was clear that the court's sympathies lay with W, and *not* H (W had made significant employment sacrifices to take care of their children, in particular, their Down-syndrome daughter). To illustrate, the court commented unfavorably on for-profit colleges, and repeated many of the probate judge's tart observations regarding H and his family, including how the "proverbial family wagons circled the family money" when H's divorce began, describing H's $170,000 salary as an assistant bookstore manager as "inflated" and flowing from "familial relations" (the court said that a "normal incumbent" in this position would earn $50,000-$60,000 a year), and noting the "machinations" that were designed to silence H's interest in the trust. As the old saying goes, however, "bad facts make bad law."

That is, putting the human factor to one side, it seems surprising that the court concluded that H had a fixed right to distributions, given that distributions were discretionary (albeit subject to an ascertainable standard); it also seems surprising that the court agreed that as one of 11 current beneficiaries, H had a 1/11 interest in the trust: this fractional approach overstates H's interest assuming more descendants are born, and understates his interest if the class suddenly contracts because beneficiaries die.

In addition, notwithstanding the court's dim view of how the trust was administered and the perceived manipulations of H's family, the trustees had a fiduciary obligation to the other trust beneficiaries. If they had agreed to H's request for distributions so that he could fulfill the court-ordered 24 monthly settlement payments to W, those distributions arguably would have fallen outside of the scope of the trust's ascertainable standard for distributions (again, "comfortable support, health, maintenance, welfare and education"). Furthermore, whether a trustee is an independent third-party or a family member or friend, that trustee is no less vulnerable to a potential suit from a disgruntled beneficiary.

Here are a few takeaways from this case: 1) full discretion on the part of trustees (as opposed to discretion that is subject to an ascertainable standard) offers more potential creditor protection to beneficiaries; 2) depending on the jurisdiction, a divorce court may be more willing to consider a beneficiary's discretionary trust interest as a divisible part of the marital estate; and 3) before they wed, beneficiaries of means may want to consider having a pre-nuptial agreement, as unromantic as such agreements can be.

No more $100,000,000 checks!

On September 7, 2015, the IRS issued Announcement 2015-23. IRS personnel were told that effective January 1, 2016, the IRS cannot accept checks over $99,999,999, as checks in excess of that amount must be processed by hand, which can lead to errors. If a taxpayer owes more than that amount, the taxpayer must use two or more checks or pay by Fed Wire. Good to know.

December 7520 rate

The IRS has issued the December 2015 applicable federal rates: the December 7520 rate remains at 2.0%, where it was in November. The December mid-term rates are: 1.68% (annual), 1.67% (semiannual and quarterly) and 1.66% (monthly). The November mid-term rates were: 1.59% (annual), 1.58% (semiannual and quarterly) and 1.57% (monthly).

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