Know Thy Trust

A plain English guide to orchestrating assets in divorce cases

BY **DEBORAH RYSSO**

All trusts are not created equal. Some are long and full of legalese; others are short and concise. Some function beautifully; whereas others have disastrous, unintended consequences. Some were highly appropriate when created; yet others were drafted just to make money. But no matter what kind of trust it is, chances are good that it will need to be addressed and changed during the course of a divorce.

Trusts are a unique vehicle available to estate planning attorneys to accomplish a multitude of goals. Trusts tend to be the longest and, therefore, the most complex of all estate planning documents. For even the most experienced estate planning attorney, ascertaining why a trust was set up in a certain way can be difficult, particularly when the client never really understood how the trust was supposed to work.

Family law attorneys must pay particular attention to trusts that surface in a divorce case. They must recognize, at minimum, that a spouse should be removed as a fiduciary and that other potentially thorny situations need to be identified.

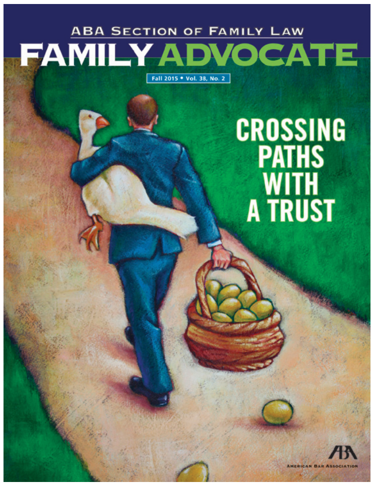
Structure of a trust

The person(s) setting up a trust is known as the "grantor" (or "settlor" or "trustmaker"). In the trust document, the grantor identifies who will serve as "initial" and "successor" trustees. The trustee has a duty to follow the terms of the trust. The grantor also identifies lifetime and at-death beneficiaries, which are the people or organizations to receive distributions from the trust.

A trust is part of a "complete estate plan." A complete estate plan includes all of the common, frequently necessary documents, such as a pour-over will, assignment of personal property, financial durable power of attorney, healthcare durable power of attorney, and deeds transferring real estate into the trust. These documents—in addition to the trust—may need to be changed during the divorce.

A client must change the estate plan during a divorce because generally the soon-to-be-ex-spouse is named to serve as a fiduciary and is a beneficiary. Often, divorcing spouses want these provisions removed. Even when spouses do not want to remove the spouse as a fiduciary and/or beneficiary, the documents should be updated to clarify that even though spouses are divorcing, they want to continue to include each other in their estate plans. This eliminates any ambiguity as to what the spouses' intentions are postdivorce. Finally, if the couple have minor children, they should identify future guardians and/or conservators for the children in the event that parents predecease children or become unable to care for children younger than age 18.

Trusts created during a person's lifetime often are called "living trusts." Others are known as "testamentary" trusts and are formed via a last will and testament and, therefore, begin after death.



Published in *Family Advocate*, Vol. 38, No. 2, (Fall 2015) p. 6-9.

Trust funding

Individuals "fund" a trust by transferring assets into the name of the trust. Usually the attorney handles the drafting and recording of deeds into the trust, but the client is responsible (with the attorney's guidance) for transferring other assets into the trust. Once transferred, the trust, rather than the individual, owns the assets, and the terms of the trust guide asset use.

One of the first tasks for a divorce attorney is to ascertain which assets are owned by the trust or which assets list the trust as beneficiary. If the trust is being amended or revoked, asset ownership and beneficiary designations must be adjusted accordingly. Further, depending on the terms of the trust, trust assets may or may not be available, which may affect the terms of the divorce judgment.

Can the trust be changed?

The first question to answer is whether the trust is revocable or irrevocable. These terms mean simply: can the trust be changed or revoked (revocable), or does the trust prohibit change or revocation (irrevocable)? The terms "revocable" and "irrevocable" do not delineate what type of trust is involved. Different types of trusts may either be revocable or irrevocable, but all revocable trusts are not the same and all irrevocable trusts are not the same.

This is a common point of confusion. People will often say, "she has an irrevocable trust." That phrasing alone is insufficient to tell what type of trust she has, or more succinctly, how the trust functions. The most common type of trust is a revocable living trust, often called a "family" trust. However, there are many other types of trusts. (See A Glossary of Trusts, on page 8.)

If the estate plan is revocable, and if your client wants to change it, he or she can and should do so. Simply draft a letter advising the other party or his or her counsel that documents have been revoked and clarify that the other party is no longer a fiduciary under the particular documents. For example:

> Please be advised that John Smith has revoked his Financial Durable Power of Attorney naming Mary Spouse as the Initial Attorney-in-Fact.

Your client should then proceed to draft and sign new documents. You may want to refer the client back to his or her estate planning attorney to ensure that this is done correctly and that the new estate plan reflects the terms of the divorce judgment.

If your client's estate plan (usually just the trust component) is irrevocable, then review with your client the effect of not being able to change the document. Frequently, irrevocable trusts set up by married couples are for the benefit of their children, and the parents are comfortable knowing that the trust will continue to benefit the children. If there is a compelling need for a change of trustee, petition the court for such a modification. Other irrevocable trusts may not be part of the divorce judgment and need careful scrutiny.

Issues easily overlooked

Quite often the client does not fully understand estate planning or details of the divorce and fails to complete his or her tasks pertaining to estate planning or the divorce judgment. Trusts are often left unfunded—meaning that the trust is drafted and signed, but assets to fund it never get transferred. This can happen with real estate, stocks and bonds, bank accounts, business assets, etc., and depending on the timing, can affect divorcing parties long after the divorce.

Other common omissions include failing to change life insurance and annuity beneficiaries and survivor beneficiaries of pensions that include survivorship rights.

If the couple had “second-to-die life insurance,” also known as survivorship life insurance, they will need to address how to handle the policy. These policies insure both spouses and do not pay out until the surviving spouse dies. Usually these benefits pass on to children of the marriage.

Attempts to hide/shield trust assets

Divorcing parties often have the desire or intention to hide or shield assets from their spouses. They sometimes get the idea that a trust might serve that purpose. This depends on the asset and state rules.

Attempting to use a trust (after the wedding) to prevent a spouse from having a claim against it usually won’t work, especially if trust assets are marital or community property. Like any other attempt to hide an asset, this would likely be frowned upon by a judge and be considered a fraudulent transfer. A judge can usually modify terms of a trust so that even if the trust stipulates it is unavailable to the divorcing parties, the judge can make it available.

There are, however, occasions when transferring assets to a trust is permissible to prevent them from becoming marital property. In noncommunity property states, setting up a trust to segregate inherited assets from marital assets ensures that those assets pass to the spouse’s family members, rather than to the other spouse’s family members. This practice is common and not indicative of an attempt to act unscrupulously.

Assets transferred into a trust prior to marriage may be shielded from a claim against a divorcing spouse, depending upon the terms of the trust and the laws of the state. For example, assets, particularly certain business assets, placed before marriage into a domestic or foreign asset protection trust or Delaware trust may help protect assets from a spouse.

Likewise, a beneficiary of an irrevocable trust (such as one set up by a deceased parent) usually can safeguard trust assets from a spouse’s claim. One caveat to remember is that whatever type of trust fund, a court may include income from the trust when calculating child and spousal support.

A divorce attorney for a spouse who has an irrevocable trust should carefully consider the terms of the trust when attempting to divide the marital estate. Irrevocable trusts can have limitations on access to the funds. So even though a division of the marital estate may seem fair on paper, the spouse with the trust may end up not having sufficient access to cash.

How enforceable is a new trust?

Sometimes a divorce arises after a trust has recently been set up. The question becomes, if the trust is funded with marital assets, does one spouse have the authority to unilaterally commit a marital asset to the trust? The answer is that it depends on the asset. For jointly owned real estate, the answer is no. Both parties must sign the deed transferring the real estate. For jointly owned bank accounts or investment accounts, usually one owner may act on the whole account. So, yes, one spouse may transfer the entire amount. However, again, if the terms of the trust are such that trust assets would theoretically be unavailable to the other party, usually a judge can modify the trust to ensure fairness.

If a trust is confusing, ask an experienced trust lawyer for his or her opinion as to its effect on the divorce. Because trusts are written for different purposes, but that purpose is not explained in the document itself, a trust can be confusing when it veers beyond traditional templates. Trusts also can be poorly drafted. Asking another lawyer for his or her opinion may save you and your client from serious trouble down the road. FA

Sidebar:

Glossary of Trusts

A savvy estate planning attorney can draft a trust to accomplish a multitude of goals, essentially from scratch. Thus, there are innumerable trust documents in the world. This may seem daunting to attorneys who do not practice in this area. The good news is that most trusts follow a certain rough template and are, therefore, easily identifiable. Furthermore, an attorney can read a trust and get a feel for its terms without having to go any further than the four corners of the trust document itself.

➡ **Revocable Living Trust.** This is the most common type of trust. It is created during the lifetime of the grantor (a.k.a. settlor or trustmaker) and can be changed or revoked during the grantor's lifetime. Usually the grantor also serves as the initial trustee and retains complete control over trust assets during the grantor's lifetime. These trusts can be "single" (for one person) or "joint" (for married couples or committed partners). Upon the grantor's death, the trust becomes irrevocable. The most common reason to set up a revocable living trust is to avoid probate. Quite often there is an alternative route to avoid probate. These alternatives also are usually less expensive upfront than a trust. However, a trust may be preferable to the less expensive options for several reasons, such as (1) the party owns real estate in more than one state, (2) there are multiple parcels of real estate, (3) the trust includes charitable distributions, (4) a party is disinheriting a child, or (5) there are multiple (second, third, etc.) marriages. A traditional revocable living trust does not remove assets from an individual's name for Medicaid, Supplemental Security Income (SSI), or VA benefits.

This trust allows assets to be used for the benefit of a disabled individual who is receiving government benefits with an asset and income test. A family, usually parents, can set up a SNT to provide for a disabled child after their deaths. The SNT also can be set up for a severely injured person who has received a personal injury lawsuit settlement.

Medicaid and SSI are the two government programs most often involved in special needs trusts. These programs provide cash benefits, medical coverage, nursing home coverage, and food assistance. To qualify for these government benefits, an individual's income and assets must not exceed a certain amount, usually no more than $2,000, a house, and a car. These government benefits, however, provide only for the bare necessities: food and shelter. A SNT can supplement necessities and reassure families that the disabled child will have access to goods and services that otherwise would be unavailable.

Traditionally drafted SNTs cannot distribute cash directly to the disabled person. Instead, the trustee must pay for goods and services to be used by that individual. Examples include (but are not limited to) a vehicle, appliances, electronics, Internet services, medical expenses not covered by Medicaid, entertainment, gasoline, haircuts, insurance, legal fees, pets, snow removal, lawn care, classes, legal fees, accountant fees, and travel expenses.

➡ **Discretionary Trust.** Under a discretionary trust, beneficiary distributions are entirely at the discretion of the trustee. Such trusts are used when the beneficiary is unable to manage his or her own finances. Sometimes discretionary trusts are used in connection with government benefits.

➡ **Irrevocable Life Insurance Trust.** This trust is used to reduce or eliminate estate taxes and pass wealth on (typically) to the next generation. The grantor essentially surrenders all rights in a life insurance policy.

➨ **Charitable Trust.** Typically charitable trusts are established as part of an estate plan to reduce or eliminate estate and gift taxes. They are set up to benefit a particular charity or the public in general.

➨ **Constructive Trust.** This is an implied trust, which requires a court to examine the facts and determine that even though no trust exists on paper, the intention was that certain assets would pass in a certain way. These trusts are "created" when a court determines that the outcome would otherwise be unfair or contrary to the facts.

➨ **Spendthrift Trust.** These trusts are usually used to protect against a beneficiary's creditors. Spendthrift trusts do not allow the beneficiary to sell or pledge away interests in the trust. Creditors may access trust assets only after they have been distributed to trust beneficiaries. (Most people set up trusts with "spendthrift provisions," rather than having a separate spendthrift trust.)

➨ **Generation-Skipping Trust.** This trust (sometimes called a dynasty trust) is used to reduce or eliminate estate taxes by allowing the grantor to pass assets to family members at least two generations apart— usually grandparents to grandchildren.

➨ **Qualified Personal Residence Trust.** Such a trust is used to reduce or eliminate estate taxes by removing the value of a home from the estate. It is particularly useful if the home is likely to appreciate in value.

➨ **Qualified Terminal Interest Properties Trust (QTIP).** A QTIP trust generally is used in situations involving multiple marriages and stepchildren. Typically QTIP trusts provide that a surviving spouse is entitled to income from trust assets, but children from prior marriages will receive the principal after the surviving spouse's death.

➨ **Totten Trust.** A grantor creates a Totten trust at a financial institution by depositing money into an account in his or her name and naming an individual or entity as the beneficiary. Most people do not think of these accounts as trusts and, thus, the term "Totten trust" is no longer commonly used. Instead, most people simply add a beneficiary to a financial account by saying, "Payable on Death to" (POD), or "Transfer on Death" (TOD). Such accounts are free and avoid the pitfalls of joint ownership and probate.

— D.R.

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A Practical Primer on Trusts

The Truth About Trusts by Eileen B. Trost is an excellent article that appeared in *Family Advocate*, Spring 2010 (Vol. 32, No. 4). It is a practical primer on how to handle trusts that surface in a divorce case. Ms. Trost explores the interesting ways trust law can affect a family law case, including the nature of the parties' interest in the trust, the ability of the parties to change the terms of the trust, and how the trust will be subject to taxation.

In case you cannot locate this back issue, we have posted this article on our website, along with the contents of this issue at www.shopaba/org/FL Trost.