The Divorce-Proof Trust: Reconsidering Estate Planning Norms

April 30, 2021 **|** by Gary Botwinick

As published in the New Jersey Law Journal, April 29, 2021

Designing an estate plan to protect an inheritance should not be reserved just to the wealthiest clients. For most clients, the risk of a child's divorce is far greater than the risk of a future estate tax. To ensure that wealth protection is achieved, the trust must be very carefully drafted.

Planning for wealth transfers to future generations is a tricky business. Attorneys counsel clients on the dangers of vesting too much wealth in a beneficiary who is too young to understand the responsibility that comes with such an inheritance. Typically, an attorney will recommend the use of a trust that restricts the distribution of the wealth until a child reaches a more "mature" age—often including staged distributions (e.g., 1/3 at 25, 30 and 35). A "staged distribution" trust allows the client to delay and/or spread out the receipt of an inheritance and to allow a trustee to manage those assets for an "immature" child.

While staged distribution trusts work well to accomplish the goal of protecting wealth for a young beneficiary, they do little to protect inherited wealth in the case of the beneficiary's future divorce. In many states, including New Jersey, inherited assets are not generally subject to equitable distribution so long as they remain in the inheritor's sole name and control. *See* N.J.S.A. §2A:34-23(h). But once distributed from a trust, they may be inadvertently or intentionally (without due consideration of the risks) comingled with marital assets, thereby placing those assets within reach of a claim for equitable distribution by a potential ex-spouse. Even if inherited assets are kept separate and apart from marital assets, they may nevertheless be considered as a resource for alimony and child support purposes, with respect to both the requirement to pay and the right to receive, and they may impact the manner in which marital assets are divided in a divorce. *See* N.J.S.A. §§2A:34-23 and 23.1.

The risks of exposing inherited wealth to an inheritor's divorce can be mitigated, and potentially eliminated, through the use of dynastic trust planning. In states like New Jersey, which have abolished the Rule Against Perpetuities, or those that have extended it to endure for multiple decades or centuries, wealthy families have employed dynastic trusts to transfer wealth from generation to generation without additional impositions of estate taxes as wealth passes to each generation. However, recommending the use of dynasty trusts merely to save estate taxes misses the more likely benefit of these trusts—protection of an inheritance from exposure in a beneficiary's divorce.

A dynasty trust can provide broad asset protection from a beneficiary's future creditors, including a future ex-spouse. Designing an estate plan to protect an inheritance should not be reserved just to the wealthiest clients. For most clients, the risk of a child's divorce is far greater than the risk of a future estate tax. To ensure that wealth protection is achieved, the trust must be very carefully drafted.

Tip 1: Don't Rely on State Default Laws

Unless the trust document explicitly limits the trustee's discretion and requires distributions from the trust, New Jersey law, in general, offers broad creditor protection for trusts with relatively few requirements. For example, the mere mention that the trust is intended to be a "spendthrift trust" is sufficient to afford some protection in the state. ***See*** N.J.S.A. §3B: 31-36(b). Additionally, New Jersey generally follows the Restatement (Second) of Trusts, ***see Tannen v. Tannen***, 416 N.J. Super. 248 (App. Div. 2010), ***aff'd***, 208 N.J. 409 (2009), which affords beneficiaries limited power to compel distributions if such distribution power is vested in the trustee's uncontrolled discretion. ***See*** Restatement (Second) of Trusts §§128 and 155(1). By extension, a creditor possesses no greater power to compel a distribution than the beneficiary does. Conversely, Restatement (Third) of Trusts generally provides that "a beneficiary of a discretionary trust has an enforceable interest in the benefits of the trust, even if the trustees are accorded the broadest discretion." ***Tannen***, 416 N.J. Super. at 269; ***see also*** Restatement (Third) of Trusts §§50 and 60.

However, since dynasty trusts are, by design, intended to endure well into the future, there is no way to ensure what law will apply at the time of a potential controversy. For example, New Jersey law may change or the trust situs and governing law of the document may change. Scriveners must account for all possibilities and must make the settlor's intent crystal clear. To maximize creditor and divorce protection, the trust must be a "purely discretionary" trust. All distributions should only be made in the sole discretion of the trustee and restrict a beneficiary's power to compel a distribution. It is critical that such distribution provisions be drafted to avoid ambiguity and potential court misinterpretation.

Tip 2: "Shall" vs. "May"

The use of the word "shall" in a trust mandates an action. Conversely, the use of the word "may" permits an action but does not require it. For maximum protection, a trustee should not be required to make distributions from the trust because that clearly gives the beneficiary the ability to compel such a distribution to be made, thus exposing the trust to risk in a divorce.

Nevertheless, the following ambiguous language is often found in trusts that are intended to be purely discretionary: ***The trustee shall distribute income and/or principal to the beneficiary in the trustee's sole and absolute discretion.*** The use of the word "shall," which seems to require the trustee to make distributions, is in direct conflict with the second half of the provision providing that distributions only be made in the sole and absolute discretion of the trustee.

A better alternative is the following: ***The trustee may, but shall not be required to, distribute income and/or principal to the beneficiary in the trustee's sole and absolute discretion.*** The use of the phrase "may, but shall not be required to," reinforces the discretionary nature of the trust and that the beneficiary has no right to compel a distribution. This mitigates the risk of a court misinterpreting the testator's (or settlor's) intent.

Tip 3: Ascertainable Standards

On one end of the spectrum, a "support trust" requires the trustee to make distributions for the beneficiary's support and gives the beneficiary a right to compel such a distribution. On the other end of the spectrum, a purely "discretionary trust" has no such requirement and therefore the beneficiary has no right to compel a distribution. However, practitioners have blended the two to create a hybrid, a “discretionary support trust.” For example, ***the trustee may distribute income and/or principal for the beneficiary’s health, education, maintenance or support in the trustee’s sole and absolute discretion.***

It is the hybrid trust that has been at the center of most litigation concerning the beneficiary’s right to compel a distribution. ***See, e.g., Tannen***, 416 N.J. Super. 248. Fortunately, with the enactment of the New Jersey Uniform Trust Code in 2016 (post-***Tannen***), the state has specifically legislated away the ambiguity as to a beneficiary’s right to compel distributions from a hybrid trust. N.J.SA. §3B:31-38(a)(1) provides the following: “Whether or not a trust contains a spendthrift provision, a creditor of a beneficiary may not compel a distribution that is subject to the trustee’s discretion, even if … [t]he discretion is expressed in the form of a standard of distribution ….”

Nevertheless, a scrivener should not assume that N.J.SA. §3B:31-38(a)(1) will ensure protection from claims in a divorce. For one, New Jersey could always change its laws. Also, beneficiaries may divorce in another state whose laws are inconsistent with New Jersey’s. Thus, avoiding the use of any ascertainable standard when drafting a purely “discretionary trust” is recommended.

Often, the use of an ascertainable standard is intended to avoid the vesting of a general power of appointment in a beneficiary serving as trustee for estate tax purposes. ***See*** IRC §2041(b)(1)(A) (“A power to consume, invade, or appropriate property for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent shall not be deemed a general power of appointment.”). Rather than putting “HEMS” language directly into the distribution standard, the following may be a better option:

The trustee may, but shall not be required to, distribute income and/or principal to the beneficiary in the trustee’s sole and absolute discretion. Notwithstanding the foregoing, however, an interested trustee (as defined herein) may only participate in such distribution decision to the extent that such distribution is for the recipient’s health, education, maintenance or support in the recipient’s accustomed manner of living.

This protects a beneficiary-trustee from being deemed to have a general power of appointment, yet avoids the trust being considered a support or hybrid trust.

Tip 4: Settlor's Intent

When in doubt, say what you mean. Scriveners may want to consider taking a page out of the special needs planning book by specifically providing in the trust that the beneficiary cannot compel a distribution. For example, ***notwithstanding anything contained herein to the contrary, the beneficiary shall have no power whatsoever to compel a distribution from the trust and the trustee shall have no requirement to make a distribution from the trust.***

Tip 5: Giving the Beneficiary Some Recourse

The above drafting tips may sound overly restrictive. After all, most clients simply wish to ensure that their children's inheritance is protected and kept in the family. But they also want to ensure that their children will not be unreasonably restrained in their use of the inherited wealth. In order to give the beneficiary some level of control, consider giving a third party the power to remove and replace a trustee. With such a power vested in a friend of the beneficiary, the beneficiary can be certain that a friendly, but still independent, trustee who would be more inclined to follow the beneficiary's wishes will do so.

Click here to view the article on Law.com.