

SPENDTHRIFT TRUSTS

By: John J. Scroggin

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I was sitting in Jim's office one afternoon as he talked on the phone. We had a meeting scheduled to discuss the planning of his large estate. As I waited Jim became more and more angry with the person he was talking with - and then slammed down the phone. He looked at me, his finger pointing out from his face, and said: "If you don't have any yet, don't ever have kids. That was my daughter. She's 38 and just went through her 4th divorce and now has moved in with another guy she wants to marry. She and these [expletive] seem to go through every dime I give her." His face was crimson during the entire ordeal.

Jim loved his daughter and wanted to protect her, but had enough empirical evidence to show that giving her money outright was not a good idea. As a part of his estate plan all assets which were allocated to her were placed in Spendthrift Trusts for the rest of her life. The trustees retained absolute discretion on whether to distribute income or principal to her. Moreover, at no time could she control the principal of the trust, nor could her creditors or future husbands pierce the trust to get at the funds she received from her father. She was also denied the right to assign the trust fund during life or death - making sure the funds passed to her siblings, not her tenth husband (she is now working on number 7).

Spendthrift Trusts have long been a part of the estate planners tools. In recent years as more and more clients express concern about asset protection and/or spendthrift children, these trusts have become a growing part of the estate planning business. Basically a spendthrift trust is any trust which provides for two major restrictions. First, it restricts the ability of any beneficiary to assign or otherwise transfer his or her interest in the trust. In most states a trust right is freely assigned by the beneficiary (e.g., as collateral for loans or for other personal purposes). Second, a spendthrift trust restricts the right of creditors of a beneficiary to demand payment of income or principal to satisfy the obligations of the beneficiary. In some states creditors are still free to garnish actual distributions to the beneficiary but are unable to force distributions in order to garnish them. In many states a statute allows certain creditors (e.g., the government) to pierce a spendthrift trust. Some states (e.g., Rhode Island, New Hampshire, Virginia) severely restrict any limitations on the creditors of a beneficiary.

In most states there is one classic limitation on spendthrift trusts: the grantor of the trust cannot create a spendthrift trust that provides for his own benefit. This exception assures that creditors are not defrauded by such a provision. However, this limitation has begun to erode as more and more clients have become concerned about asset protection. The inability of a grantor to set up a US based spendthrift trust for himself has resulted in the massive growth of off-shore trusts. In an attempt to bring some of that money back into their states, a number of states (e.g., Alaska, Delaware and Missouri) have begun changing the rules, by allowing grantors to set up spendthrift trust for their own benefit if certain conditions are made. Although serious questions have been raised about the effectiveness of

these trusts as an asset protection tool, they do offer some potential benefits

Spendthrift trusts as an asset protection tool work in other areas:

- The classic spendthrift trust is the ERISA retirement trust. In the United States Supreme Court decision, Patterson vs. Shumate, the court severely restricted the right of creditors to pierce an ERISA governed retirement plan. This enabled O.J. Simpson to continuously receive income from his ERISA retirement plan even while denying payments to his judgment creditors. IRAs are not generally provided spendthrift protection.
- Joe has an adult child who is severely disabled and receives various governmental support payments. If the child inherits Joe's assets directly she will lose those governmental benefits. Instead Joe conveyed her inheritance through a Spendthrift Supplemental Trust which provides that the benefits to the child "supplement" any governmental help and restricts the right of the government to demand payments from the trust. To add one more layer of protection, Joe's other children are also beneficiaries of the trust and the trustees have absolute discretion on whether to provide distributions to the disabled child or the other children. Beware that state governments have tried to erode the benefit of such trusts.

Spendthrift trusts have a multitude of other practical applications:

- Jimmie has spendthrift children who live well above their means. Jimmie is convinced that every dime she gives to her children will be spent in ways she disagrees with. She is also concerned that assets be available to educate her 8 grandchildren. The answer is a Generation-Skipping Spendthrift Trust. This trust can provide designated benefits to children over their life time without the children being able to spend the underlying dollars held in the trust. If Jimmie is concerned that her grandchildren will mimic their parents, she could provide that the trust continues across successive generations by making it a Dynasty Spendthrift Trust.
- Jan has been married 13 years to her second husband and has five children by her prior marriage. She wants to provide for her husband when he dies, but wants to assure that assets pass to her children after his death. She is concerned that if he remarries, the new spouse may try to access her funds during the marriage or at divorce. Jan established a Q-TIP trust with spendthrift provisions which restricted her husband and his creditor's (including any new wife) rights to the trust funds. At his death, the trust assets are paid to her children.
- John's son has significant marital and financial problems. John is concerned that if his son inherits his assets, the funds will be paid to a divorcing spouse or to creditors. The son's inheritance was placed in a discretionary spendthrift trust and a third party (e.g. a sibling) was given the authority to terminate the trust at some time in the future - after the financial or marital problems have ceased.
- George is a doctor in his second marriage with children from the prior marriage. He is considering retiring in the next few years and is concerned about the lingering medical malpractice liability which could occur. He has significant assets but his spouse (who has no children) has nominal assets. George gifted to his spouse \$625,000.00 (i.e., the amount of the unified credit). A year later, the spouse would convey \$625,000.00 into a lifetime unified

credit trust which named George as the primary beneficiary and granted him a special power of appointment to transfer the assets to his children in trust or outright at any time. The trust contains a spendthrift provision which would restricts the right of his creditors to pierce the trust.

One helpful addition to the spendthrift trust provision is a non-contest provision. Although no-contest provisions are outlawed in a few states, they can serve as useful impediment to a heir or creditor who wants to pierce the spendthrift provisions of his or her trust. In addition, except in the case of a martial trust, the spendthrift provision can provide that the attempted assignment by a beneficiary of his or her trust benefits would automatically terminate those benefits.

Virtually every type of trust should contain a spendthrift provision. It's simply good planning.

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