Balanson: Drafting Trusts to Deflect the Spousal Creditor

by Nancy R. Crow

Estate planners, not domestic relations lawyers, are perhaps most truly family lawyers. It is estate planners who work to preserve family relationships, create family harmony, and protect hapless family members from themselves as well as the IRS. How appropriate it is, then, to look to the Colorado Supreme Court's recent family law analysis in *Balanson v. Balanson*[1] for guidance as estate practitioners draft trusts for their clients.[2] This article discusses the case law leading up to the *Balanson* ruling and the implications of the treatment of future interests in trusts as marital property on honing trust distribution clauses.

Division of Trust Assets in Divorce

Asset protection has become an often-sought goal of estate planning clients. Clients wish to ensure financial security and independence for children, grandchildren, or other loved ones while keeping the funds away not only from general creditors, but sometimes from a potential (or actual) greedy spouse or ex-spouse. Estate planners are frequently asked to draft trusts that will accomplish these objectives.

Suppose Mrs. Porter appears in her attorney's office, still chafing from her own dissolution proceeding in which her ex-husband ended up with a share of the appreciation during the marriage in the family residence, even though her parents bought the home for their child (Mrs. Potter) and her offspring. Mrs. Porter may be determined that her own children will never meet a similar fate. She asks her lawyer to write a trust that will take generous care of her children, but be beyond the clutches of their spouses. The most recent developments in the Colorado law defining marital property in dissolution of marriage actions make these requests from doting relatives more challenging than ever.[3]

In short, CRS § 14-10-113(1) requires an equitable distribution of marital property on dissolution of a marriage. Property acquired before the marriage is separate property and is not divided between the parties. However, it may be taken into account as an "economic circumstance" affecting how the marital property is to be divided, as well as the appropriateness of awarding maintenance to either spouse.[4] All property acquired by either spouse during the marriage is considered marital property, except for: (1) property acquired by gift, bequest, devise, or descent; (2) property acquired in exchange for property acquired prior to the marriage or in exchange for property acquired by gift, bequest, devise, or descent; (3) property acquired by a spouse after a decree of legal separation; and (4) property excluded by valid agreement of the parties.[5] Whether a trust is established before or after the marriage began, it will most likely be a gift or bequest from a third party and thus should fall within the exclusion.

Although the initial trust interest is separate property, the trust interest may still come under the marital property umbrella. Any increase in value in separate property acquired either before the marriage, or under numbers (1) or (2) above, may be considered marital property.[6] The crucial inquiry in the dissolution proceeding, then, is to determine whether a trust beneficiary has a sufficient degree of control over, or benefit from, the trust for the beneficiary's interest in the trust to amount to a property interest. If it does, the appreciation in value of the beneficiary's interest during the course of the marriage must be treated as marital property and distributed equitably.

This can be the case even if the court has no ability to order a trustee, not generally a party to the dissolution action, to distribute property from the trust to one or both of the divorcing spouses. The court will, if it has gotten this far in the analysis, generally allocate the marital property interest in the trust to the trust beneficiary and compensate the other spouse with other marital assets, if they exist.

Dissecting a Trust Beneficiary's Interest

A trust provides a mechanism for dividing the burdens and benefits of owning property among more than one person.[7] The trustee, as fiduciary, is saddled with the burdens of managing the property, while one or more beneficiaries may share the bundle of benefits associated with the property. Those benefits vary greatly from one trust to the next. Typically, one beneficiary may have the right to income from the trust on either a mandatory or discretionary basis, while another individual or group may have the right to receive some portion or all of the principal at some point in the future.

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Colorado cases examining whether a trust beneficiary has sufficient control over a trust to amount to a property interest have usually concerned dissolution actions in which one spouse had a current right to receive income or principal distributions from the trust. In contrast, *Balanson* involved a trust in which the wife neither received, nor had a right to receive, any current distributions from the family trust established by her parents.

In *Balanson*, the wife's parents had adopted a common, even routine, estate planning approach. They set up a revocable trust. On the wife's mother's death, the trust became irrevocable. It was divided into two trusts, a marital trust ("Trust A") and a family trust ("Trust B"), presumably to take advantage of each spouse's exemption from estate taxes.[8] Although the family trust had sufficient limitations on distributions of principal to avoid inclusion in the wife's father's estate, the father was the sole trustee and he alone had the right to distributions from both trusts during his lifetime. The wife's father received all income from both trusts, and he had the discretion to distribute principal to himself for his "support, care and maintenance." If a trustee/beneficiary's access to the principal of a trust is limited by an "ascertainable standard," typically "health, education, support or maintenance," the trust principal will not be included in that trustee/beneficiary's taxable estate.[9]

A general power of appointment gave the wife's father the right to designate in his will how the marital trust would be distributed following his death. This testamentary power caused the marital trust to form part of his taxable estate. Any unappointed portion, as well as the entire family trust, would be divided in half and distributed to his then-living children. As one of two children, the wife in *Balanson* thus was found to have a vested future interest in the trust principal, although the time and the amount of payment were uncertain.

The court based its ruling in part on its 1976 ruling, *In re Question Submitted by the United States Court of Appeals for the Tenth Circuit*.[10] In that case, as in *Balanson*, a decedent's child had the right to trust distributions only after the surviving spouse's death. If the child died before the surviving spouse, the trust provided for an alternative disposition. The court held that the child's future interest was, in the language of future interests, "a vested remainder subject to complete defeasance." As such, it constituted a property interest to which a federal tax lien filed against the child could attach.

Similarly, in *Balanson*, the wife's future interest in her mother's trust constituted a property interest. Should the wife's father consume the entire trust corpus for his living expenses, her interest would become worthless. Likewise, she would receive nothing if she died before her father. Although these future events could not be known, the probability of their occurrence could be assessed. The Colorado Supreme Court assumed that the remainder interest could be valued, just as could future pension benefits.[11] The court directed the trial court to treat the increase in value of the wife's trust remainder between the time it was created and the time of the decree as marital property. To determine the present value of the remainder interest, the Supreme Court suggested that the trial court could use actuarial data concerning the father's life expectancy, as well as the likelihood and extent to which he would need to invade principal for living expenses during his lifetime.

Pension benefits, like many trust interests, may be contingent on the beneficiary's survival. For example, a pension benefit may be conditioned on the plan participant's continuing to work for the same employer for a set period of time or reaching a specified age.

Similarly, a remainder interest in a trust may be conditioned on the beneficiary's outliving the income beneficiary. However, there are many significant differences between pensions and trusts. Pension rights are considered to accrue during a plan participant's work life, as a form of compensation. Continuing to work is generally within the participant's control. To the extent that the benefits can be considered compensation earned while the participant was married, it seems in keeping with Colorado courts' treatment of compensation in general to treat benefits as marital property.

In contrast, a trust interest may appreciate or depreciate without action or control on the remainder beneficiary's part. Pension benefits may not be diverted to a third party's use. A trust interest could be divested by the exercise of a power of appointment or by a trustee's power to invade principal for the benefit of a third party (as was the case in *Balanson)* to terminate an uneconomical trust or to hold property in further trust if a beneficiary should be disabled. None of these events is subject to precise actuarial calculation.

The case of *Balanson* should prove lucrative to actuaries, who can make use of mortality tables and statistics concerning average living expenses to project the value of a future interest. Still, it seems ironic that parents who establish a trust for the surviving spouse (with the remainder to be paid on death to their descendants) should impose a significantly greater burden on their children, at least those whose marriages dissolve, than if they had given all property outright to the surviving spouse, who would plan on leaving whatever was left to their descendants on his or her subsequent death. *Balanson* may make current income beneficiaries of trusts reluctant to provide testimony to domestic relations judges concerning their own assets, needs, and lifestyles. It may be prudent estate planning, and appropriate family welfare planning, to draft trusts in a manner that minimizes the possibility that trustees and beneficiaries will be dragged, kicking and screaming, through the glare of courtroom lights.

Drafting Techniques

The question becomes, then, how to draft trusts that will protect clients' present and future beneficiaries. First, it seems reasonably clear under Colorado law that a trust beneficiary does not have a property interest in a purely discretionary trust. If a trustee, preferably an independent one, has complete say concerning the amounts and timing of distributions of principal and interest, and the beneficiary has no enforceable right to distributions, the beneficiary's interest will not amount to a property interest and cannot be treated as marital property. Similarly, such a trust will guard against claims of other creditors, protect beneficiaries from their own spendthrift tendencies, and minimize transfer taxes.

This year, Colorado abolished the Rule Against Perpetuities ("Rule") with respect to trusts whose income or principal may, in the trustee's discretion, be distributed to a person who is living when the trust is created.[12] Trusts can, if drafted to comply with this now nearly nonexistent Rule, continue indefinitely. Even if a trust does have a designated termination date or event far in the future, the beneficiaries will own vested remainders in the trust, subject to defeasance, but the value of those remainders, while calculable, could be too remote to be worth the actuarial fees.

A client determined to avoid even this remote possibility may wish to engage the

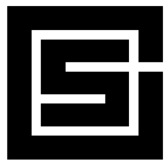
services of a trustee in one of the states that has completely abolished the Rule. South Dakota offers a veritable army of corporate trust departments eager to manage so-called "dynasty trusts" in perpetuity in a jurisdiction that remains, for now, free of state income tax. Untold generations of beneficiaries can be protected from over-grasping spouses and other creditors, but at the expense of losing the right to manage their own capital to carry out their dreams.

Rather than giving a trustee unbridled discretion, clients may prefer to require that income be paid out periodically to one or more beneficiaries. Amounts paid out to married beneficiaries will become marital property and may be used to purchase marital assets, but if the beneficiary has no right to principal, or one limited by an ascertainable standard, the trust principal need not be valued in the beneficiary's dissolution action.[13] Of course, the beneficiary's trust interest may still be taken into account as an economic circumstance in the division of marital property and possible award of maintenance.

Another approach is the liberal use of powers of appointment, frequently handy tools in the estate planning arena. Rather than relinquishing unfettered discretion to the trustee, even accompanied by precatory guidelines, the client may wish to give a trusted advisor or family friend the opportunity to direct the distribution of trust assets. For example, a trust for the surviving spouse might grant the family accountant the right, as trust advisor or trust protector, to determine when, following the surviving spouse's death, a couple's children have learned enough management skills to be worthy of significant principal distributions or trust termination. The trust document could provide guidelines to assist the trust advisor in determining whether the trust beneficiary is ready for a distribution.

Such guidelines may allow the trust to authorize distributions of principal to make investments or start businesses that, in the trust advisor's (or trustee's) judgment, have a reasonable likelihood of success. Similarly, the guidelines could urge the trustee to consider terminating the trust and distributing its assets to the grantor's descendants at such time that the trustee believes they have demonstrated maturity by maintaining a committed relationship for a stated period of time and that appears likely, in the trustee's judgment, to continue.

A true dynasty trust can raise the specter of the generation-skipping transfer tax.[14] The maximum amount that can be passed more than one generation down from the donor before the generation-skipping transfer tax is imposed is $1,060,000 for 2001 through 2003. Starting in 2004, it parallels the estate tax exemption. Because the tax equals the highest estate tax rate, it sometimes makes sense to limit a generation-skipping transfer to the amount exempt from the tax. This can be accomplished by giving non-skip persons (usually the client's children) a general testamentary power of appointment over trust assets.[15] The trust assets thus will become taxable in the non-skip persons' estates, which may result in a lower overall tax, depending on the beneficiary's other assets. Whether a power of appointment exercisable only at death constitutes a property interest is unclear under current Colorado law. As noted in a 1998 article, if a testamentary power holder is not the sole lifetime beneficiary, the value of any property interest should be nominal.[16]



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Spendthrift clauses that prevent a trust beneficiary from selling, assigning, or hypothecating the trust interest are commonplace, almost boilerplate. Such clauses clearly diminish the beneficiary's property rights. At a minimum, a spendthrift clause lessens the value of the beneficiary's property interest; in combination with other restrictions on the beneficiary's rights, it may preclude treatment of the trust interest as property at all.

Neither the Supreme Court nor the Court of Appeals in *Balanson* appeared to differentiate between the family trust and marital trust, although the wife could lose any claim she might have to the marital trust assets should her father exercise his testamentary power of appointment over it. Unlike the family trust interest, the wife's interest in the marital trust seems as speculative as any future inheritance. What she will receive from the marital trust depends on what her father's will provides. It will no doubt strike clients (and many of their lawyers) as odd that the appreciation of property that will be inherited on termination of a trust at some unknown date in the future is marital property, while the possibility of receiving a future inheritance is not.

The next question is whether anything should be done to protect the beneficiaries of existing trusts. Bypass, family, or credit shelter trusts (different terms for the same concept) for the benefit of surviving spouses and their offspring abound. They were established, in many instances, to make use of the full estate tax exemptions of both spouses.

Suppose one spouse died several years ago, leaving a credit shelter trust that now holds $600,000; the surviving spouse's separate assets are worth another $600,000. In 2002, the surviving spouse could have an estate worth as much as $1 million before an estate tax would be imposed. If the bypass trust permits principal distributions, it may make sense to distribute as much as $400,000 to the surviving spouse.[17] The value of the trust remainder interests would decrease, lowering the value of any potential marital property in the heirs' dissolution actions. As an additional, and significant, benefit, the couple's heirs would reap the benefit of a stepped-up basis in the assets at the death of the surviving spouse.

Similarly, trusts that permit distributions to a multi-generational group of descendants could spread the wealth. Once property is distributed from a trust, it would seem to be treated as separate property received by gift; appreciation treated as marital property would begin with the date of distribution, and the appreciation that occurred during the time the property was held in trust would no longer be taken into account in the marital property calculation.

Conclusion

Planning to protect trust assets from a trust beneficiary's present or future spouse requires creative and careful drafting. The analysis of marital property interests in dissolution actions lends itself to a somewhat different focus than the usual asset protection techniques. Limiting beneficiaries' rights to demand trust distributions, receive principal distributions, terminate trusts, or challenge a trustee's actions may avoid treatment of the trust interest as marital property. Estate planners should advise clients seeking asset protection of this nature for the friends and family members they wish to inherit their estates of both the benefits and drawbacks of establishing these sorts of restrictions.

NOTES

1. 25 P.3d 28 (Colo. 2001). *Balanson* also considers the appropriate treatment of unexercised stock options, which is a significant issue, but not one relevant to this discussion.

2. Kirch, "Avoiding Appreciation in Trust Assets Being Treated as Marital Property," 27 *The Colorado Lawyer* 57 (March 1998). Written by the "Estate and Trust Forum" column editor, the 1998 article addresses the issues discussed in this present article and deserves review by any attorney seeking guidance in this complicated and changing area of law. The 1998 article offers many helpful hints on drafting trusts to avoid the treatment of trust property as marital in the post-*Balanson* era, and recommends the use of marital agreements, if possible, to address this issue before a dissolution battle looms. It offers useful direction in how to ensure that a marital agreement will hold up in court. A more general discussion of the treatment of trusts in the division of marital assets can be found at Note, "The Trust in Marital Law: Divisibility of a Beneficiary Spouse's Interests on Divorce," 64 *Tex. L.Rev.* 1301 (1986).

3. Lass and Seidman, "Property or Expectancy: The Division of Trust Assets at Dissolution of Marriage," 30 *The Colorado Lawyer* 63 (Feb. 2001). This article was written before the Supreme Court reversed the Court of Appeals' decision in *Balanson* and discusses the Colorado approach to the division of trust interests in the dissolution of a trust beneficiary's marriage. Readers seeking a more extensive discussion of the background to the current state of the law are urged to seek guidance there.

4. CRS § 14-10-113(1)(c).

5. CRS § 14-10-113(2).

6. CRS § 14-10-113(4). The statute has no effect on property that was never "acquired" by either spouse.

7. Crow, "Trusts," *Colorado Methods of Practice* ¶ 106.1, Ch.106 (St. Paul, MN: West Pub., 1999); Scott and Fratcher, *The Law of Trusts*, § 2.6 (Little, Brown and Co. 1987).

8. Property passing outright to a surviving spouse is not subject to estate tax because of the marital deduction, but if a decedent gives his or her entire estate to the surviving spouse, the decedent loses the ability to give an amount equal to the estate tax exemption to others. By taking advantage of both of their exemptions, rather than just the survivor's, a married couple can double the amount they can pass to younger generations free of estate tax. The exempt amount was $600,000 for many years; it is $675,000 for 2001. Under the Taxpayer Relief Act of 1997 (Pub.L. No. 105-34), the exemption was scheduled to rise in increments until it reached $1 million in 2006. That schedule has been accelerated by the Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub.L. No.107-16); the exemption will reach $1 million in 2002 and continue to increase, while the maximum estate tax rate decreases periodically until 2010, when the estate tax is slated for repeal, at least for one year.

9. IRC § 2041. While the usual language is "health, education, support or maintenance," it is likely that "care" would be interpreted as imposing the same restraints.

10. 553 P.2d 382 (Colo. 1976).

11. *See In re Marriage of Gallo*, 752 P.2d 47 (Colo. 1988); *In re Marriage of Grubb*, 745 P.2d 661 (Colo. 1987).

12. CRS § 15-11-1102(1)(c). *See* The Alaska Trust Study Subcommittee, Marsh, Stover *et al.*, "The Rule Against Perpetuities: What's the Fuss?" 30 *The Colorado Lawyer* 55 (July 2001).

13. *See In re Marriage of Foottit*, 903 P.2d 1209 (Colo.App. 1995), which states that an investment acquired with income distributed from a trust that was agreed to be the separate property of the wife was marital property.

14. IRC §§ 2601 *et seq.* The federal generation-skipping transfer tax is scheduled for repeal, along with the estate tax (but not the gift tax) in 2010, to return in 2011 unless Congress makes the repeal permanent.

15. A general testamentary power of appointment gives the donee of the power, who need not have any other interest in the trust, the right to direct distribution of the trust property by will to anyone, including the donee's estate, the donee's creditors, and the creditors of the donee's estate. CRS § 15-2-103(1).

16. Kirch, *supra*, note 2.

17. If the credit shelter trust requires that principal distributions be limited to the surviving spouse's health, maintenance, support, or education, the distribution must be justified under those guidelines. The decision should be thoroughly documented. ■