



All is Fair in Love and Trust
Law: Trust Interests, Trust
Decantings, and Domestic
Asset Protection Trusts

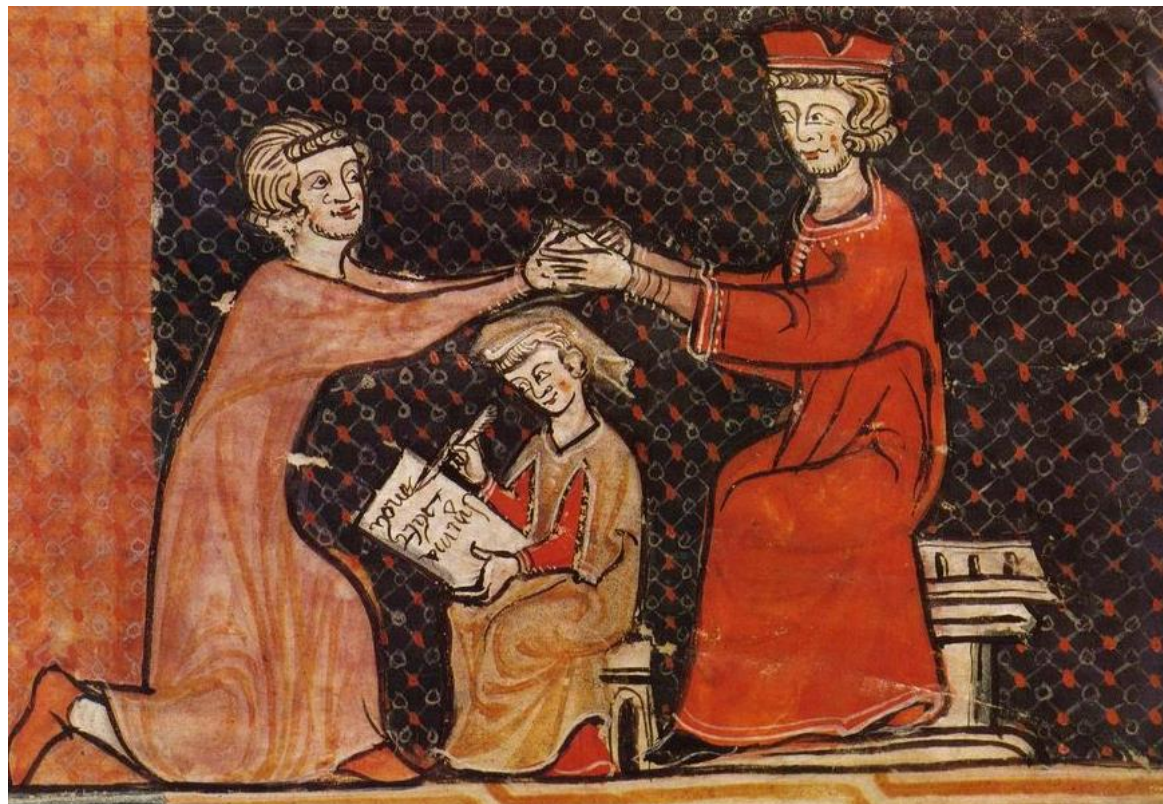
Course Agenda

- ❖ Define common terms used in trust law and common rights and powers granted to trust beneficiaries;
- ❖ Discuss what rights and/or powers under a trust agreement can cause a trust interest to be property under Colorado law and when trust distributions can be considered income for purposes of spousal maintenance and/or child support;
- ❖ Discuss *Ferri v. Powell-Ferri* and the implications of trust decantings in divorce proceedings;
- ❖ Review history and theory beyond domestic asset protection trusts (“DAPTs”), their use by nefarious spouses, and ways to attack them; and
- ❖ Questions and Answers on presentation topics.

Quick Background

- ❖ While trusts are often thought of as “things” or “entities,” at their simplest they are a legal relationship. A grantor gives property to a trustee to hold for the benefit of the beneficiaries.
- ❖ Modern trust law traces its origins to the 12th century. At the time, the one who held title to land had all legal rights to it, including the obligation to pay feudal dues to the Crown. Thus, an absentee landlord could cause an estate significant problems. English noblemen leaving for the Crusades would therefore give their estate to another to manage while they were away, with the expectation that title would be reconveyed upon the nobleman’s return.
- ❖ Of course, not all who held title for an absentee nobleman returned it upon request. Without legal remedy under the common law, cheated noblemen would often turn to the Court of Chancery, leading to fiduciary law becoming a part of the broader concept of the law of equity.

An “Homage” to Trust Law



Common Trust Terms

- ❖ **Grantor**: The individual who gives property to a trustee to be held for the beneficiaries, also known as the “settlor” or “trustor” or “trustmaker.”
- ❖ **Revocable Trust**: A trust that may be amended or revoked by the grantor. The most common application of revocable trusts is as a probate avoidance mechanism or will substitute.
- ❖ **Irrevocable Trust**: Unlike a revocable trust, an irrevocable trust cannot be amended or revoked by the grantor. The purpose of irrevocable trusts are to facilitate lifetime gifting, tax planning, and asset protection.

Common Trust Terms (Continued)

- ❖ **Discretionary Interest**: An interest in distributions of income and/or principal that is subject to the trustee's discretion.
- ❖ **Mandatory Interest**: The beneficiary has a guaranteed right to distributions of income and/or principal.
- ❖ **Remainder Interest**: A beneficial interest in the income and/or principal of a trust that takes effect or "vests" at a future date.
- ❖ **Vested Remainder Subject to Divestment**: The remainder interest has vested in the beneficiary, but the beneficiary could be divested of the interest if certain future events occur i.e., the beneficiary dies before reaching a certain age or fails to survive a lifetime beneficiary.

Common Trust Terms (Continued)

- ❖ **Power of Appointment**: A nonfiduciary power to vest the income and/or principal of a trust in a class of individuals or entities. A power of appointment may either be a lifetime (inter vivos) power or a testamentary power.
- ❖ **General Power of Appointment**: A power of appointment in which the powerholder, the powerholder's estate, the powerholder's creditors, and/or the creditors of the powerholder's estate are eligible class members.
- ❖ **Limited/Special Power of Appointment**: A power of appointment that is not a general power.
- ❖ **Spendthrift Clause**: A provision in a trust agreement preventing the voluntary or involuntary assignment of a beneficial interest.
- ❖ **Withdrawal Right**: A right held by a beneficiary to withdraw a certain amount of principal from a trust.

Enforceable Rights: Can the Beneficiary Take from the Trustee?

- ❖ **Trusts as Property**: Under Colorado law, spouses receive their separate property while the court divides marital property among the spouses “in such proportions as the court deems just...” C.R.S. § 14-10-113(1).
 - ❖ C.R.S. § 14-10-113(2)(a) provides that separate property includes property acquired by “gift, bequest, devise, or descent.”
 - ❖ The appreciation from separate property is marital property. *In re Krejci*, 2013 COA 6, ¶ 13.
 - ❖ The income from separate property is marital property. *Cardona v. Castro*, 321 P.3d 518, 522 (Colo. App. 2010).
- ❖ **Big Picture (Property Right)**: Does the beneficiary have an enforceable right to either income or principal? In other words, can the beneficiary move trust assets from the trustee’s hands to the beneficiary’s hands?
 - ❖ Yes: Then a property interest likely exists.
 - ❖ No: No property interest.

Enforceable Rights: Can the Beneficiary Take from the Trustee?

- ❖ **Revocable Trust:** A revocable trust offers no creditor protection under Colorado law and assets in a revocable trust are subject to division as to the grantor. *In re Marriage of Seewald*, 22 P.3d 580, 586 (Colo. App. 2001).
 - ❖ Under C.R.S. § 14-10-113(7)(b), a remainder interest in a third-party revocable trust is not property. The logic underlying the statute is that a revocable trust, in many respects, is a will substitute and can be revoked or amended by the grantor at any time and for any reason.
- ❖ **Discretionary Interest:** A beneficial interest subject to the trustee's discretion in a trust is not a property interest because "the beneficiary of a discretionary trust has no contractual or enforceable right to income or principal from the trust..." *In re Marriage of Jones*, 812 P.2d 1152, 1156 (Colo. 1991).

Enforceable Rights: Can the Beneficiary Take from the Trustee?

- ❖ **Vested Remainder Subject to Divestment:** Certain vested remainders subject to divestment are a property interest because they are “a present fixed right to future enjoyment...not within the discretion of the trustee to withhold.” *In re Marriage of Balanson*, 25 P.3d 28, 41 (Colo. 2001) (commonly referred to as *Balanson II*).
 - ❖ Trust in *Balanson II* would distribute remainder interest to spouse only if (i) her father did not deplete the trust and (ii) she survived her father.
 - ❖ Notably, there was another trust in *Balanson II* over which the father had a general power of appointment. While the Supreme Court of Colorado did not directly address this trust, at no point in the proceedings did the parties contest that this trust was not property.
 - ❖ There is no direct authority on if a limited/special power of appointment is sufficient to render a vested remainder interest too uncertain to be property. *But see In re Marriage of Dale*, 87 P.3d 219, 225 (Colo. App. 2003) (upholding discount accounting for the exercise testamentary power of appointment by the wife's father).

Enforceable Rights: Can the Beneficiary Take from the Trustee?

- ❖ **Mandatory Income Interest with No Vested Remainder in the Principal:** If the beneficiary has no remainder interest, a mandatory income interest is not property. *In re Marriage of Guinn*, 93 P.3d 568, 570-72 (Colo. App. 2004).
 - ❖ Trust agreement in *Guinn* granted trustee discretion in determining what should be allocated to principal and income
 - ❖ Beneficiary could not direct trust's investments
 - ❖ The income is a "mere gratuity derived from the beneficence of the settlors."
- ❖ **Mandatory Income Interest with a Vested Remainder in the Principal:** An income interest is property where the beneficiary does have a remainder interest. *In re Marriage of Foottit*, 903 P.2d 1209, 1212 (Colo. App. 1995).
 - ❖ A vested remainder interest is separate property and the income from separate property is marital property.

Enforceable Rights: Can the Beneficiary Take from the Trustee?

- ❖ **Sole Lifetime Beneficiary as Trustee of Trust**: Under Colorado law, a beneficiary may also serve as trustee.
 - ❖ Colorado law limits a trustee who is also a beneficiary to distributions subject to an “ascertainable standard” of health, education, maintenance, and support. C.R.S. § 15-5-814.
 - ❖ A beneficiary/trustee is still subject to fiduciary duties to remainder beneficiaries, assuming there are some.
 - ❖ Key Question: What discretion does the beneficiary/trustee have to distribute the remainder interest? For example, does the trustee/beneficiary have a general or limited/special power of appointment?

Enforceable Rights: Can the Beneficiary Take from the Trustee?

❖ Lifetime General Power of Appointment and Withdrawal Rights:

- ❖ A lifetime general power of appointment allowing the powerholder to vest trust principal in the powerholder should be separate property under Colorado law because it is an enforceable right and the trustee has no discretion over the exercise of the power.
- ❖ Many trust agreements allow a beneficiary to withdraw a certain amount of principal upon reaching a certain age. For example, the agreement might let the beneficiary withdraw all trust assets at age 50. This type of withdrawal right should be treated as a lifetime general power of appointment.
- ❖ Even if the beneficiary has not reached the threshold age, the right to withdraw principal should be treated as a vested remainder subject to divestment per *Balanson II*.

Enforceable Rights: Can the Beneficiary Take from the Trustee?

❖ Crummey Power and 5 and 5 Power:

- ❖ A common estate planning strategy is for parents or grandparents to create a so-called “Crummey Trust” that allows the grantor to make gifts to the trust that are not taxable because they use the annual gift tax exclusion. In a Crummey Trust, the sequence of events works as follows:
 - ❖ Each parent makes a gift equal to the annual exclusion amount (\$17,000 each) to the beneficiary;
 - ❖ The beneficiary has a limited window of time (e.g. 60 days) to withdraw the \$17,000 gift; and
 - ❖ If the beneficiary doesn't exercise the withdrawal right, the withdrawal right lapses and the gift becomes a part of the principal.
- ❖ For tax purposes, the amount of the lapse is usually limited to the greater of \$5,000 or 5% of the trust principal. Any excess carries over to the next year. This is known as a “hanging withdrawal right.”

Enforceable Rights: Can the Beneficiary Take from the Trustee?

❖ Crummey Power and 5 and 5 Power as Property:

- ❖ Crummey Power: Arguably property, but highly unlikely that a Crummey gift will be made during divorce proceedings.
- ❖ 5 and 5 Power: In a case involving creditors' rights, the Colorado Court of Appeals held that creditors could not attach a 5 and 5 power because the property subject to the power of appointment does not vest until the power is exercised. *Univ. Nat'l Bank v. Rhoadarmer*, 827 P.3d 561, 563 (Colo. App. 1991). However, this a minority position and most commentators agree that a lifetime general power of appointment is property. *Restatement (Third) of Trusts* § 56 cmt. b.
- ❖ Lapsed Withdrawal Rights: Arguably not property because, following the lapse, the beneficiary has no enforceable right to the property unless granted by another provision of the trust agreement.
- ❖ Hanging Withdrawal Rights: Hanging withdrawal rights are no different than a lifetime general power of appointment and should therefore be classified as property.

Trust Distributions as Income

- ❖ C.R.S. § 14-10-114(8)(c)(I)(L) and C.R.S. § 14-10-115(5)(a)(I)(L) both provide that "trust income and distributions" are includable when calculating gross income.
- ❖ Is the principal or income being used (or may it be used) "as a source of income either to meet existing living expenses or to increase the recipient's standard of living"? *In re AMD* 78 P.3d 741, 746 (Colo. 2003); *In re Marriage of Schaefer*, 2022 COA 112, ¶ 20:
 - ▶ Yes. Income
 - ▶ No. Not income.
- ❖ Note that a spendthrift provision is unenforceable against a child support order. See C.R.S. § 15-5-503(2)(a). However, the only remedy is to attach future and present distributions. See C.R.S. § 15-5-503(3). In other words, a trustee cannot be compelled to make a distribution it was not otherwise mandated to make under the trust agreement. C.R.S. § 15-5-504.
- ❖ Spousal maintenance is not an exception to a spendthrift clause. See C.R.S. § 15-5-503.

Ferri v. Powell-Ferri: Background

- ▶ Husband was the beneficiary of an irrevocable trust and had a presently exercisable general power of appointment allowing him to vest 75% of the trust principal in himself.
- ▶ The trustees, one of whom was husband's brother, administered the trust in Massachusetts.
- ▶ Husband and wife were residents of Connecticut and wife filed for divorce in Connecticut.
- ▶ The trustees, without discussing it with husband, decanted the trust into a new trust that eliminated the husband's general power of appointment.

Ferri v. Powell-Ferri: Trust Decanting

- ▶ A trust decanting is primarily a method for “amending” an otherwise irrevocable trust. The trustee exercises its discretion to distribute the principal of the first trust to distribute all of such principal to a second trust, which may have different terms than the first trust.
- ▶ There are generally three ways a trustee may obtain a decanting power:
 - ▶ Common Law: “The general rule...is that the power vested in the trustee to create an estate in fee includes the power to create or appoint any estate less than a fee unless the donor indicates a contrary intent.” *Phipps v. Palm Beach Trust Co.*, 196 So. 299, 301 (Fla. 1940).
 - ▶ Statute: Numerous states, including Colorado, have adopted the Uniform Trust Decanting Act.
 - ▶ Ascertainable Standard: May only change the non-dispositive terms of the trust.
 - ▶ Non-Ascertainable Standard: May change the dispositive terms of the trust (except for vested rights) and eliminate beneficiaries.
 - ▶ Divorce: Colorado law does not allow a decanting to impact a court’s right to divide assets in divorce proceedings. C.R.S. § 15-16-903(a)-(b).
 - ▶ Trust Agreement: The trust agreement may expressly grant the trustee a decanting power.

Ferri v. Powell-Ferri: Results

- ▶ The Connecticut Supreme Court certified several questions to the Massachusetts Supreme Judicial Court, including whether the decanting was valid under Massachusetts law.
- ▶ Upon a determination by the Massachusetts Supreme Judicial Court that the terms of the trust agreement and Massachusetts common law permitted the decanting, the Connecticut Supreme Court held that the assets of the decanted trust were not property.
- ▶ The Connecticut Supreme Court further held that the husband had no duty to recover the assets of the decanted trust.

Ferri v. Powell-Ferri: Implications

- ▶ Decanting and Divorce: There is no Colorado case law on point. A decanting done unrelated to divorce that eliminates a potential marital property interest likely would be considered valid. If a decanting is done with the clear intent to remove assets from the marital estate, there are several arguments that could be made:
 - ▶ No Common Law Decanting Power: The Supreme Court of Colorado, along with many others, has yet to hold that there is a common law decanting power under Colorado law.
 - ▶ Breach of Fiduciary Duty/Control: Did the trustee breach its fiduciary duty to the other beneficiaries by decanting? Was there an express or implied agreement with the trustee to decant?
 - ▶ Decanting Act: If the decanting was done under Colorado's Decanting Act, then it should not affect property division.
 - ▶ Public Policy: Under C.R.S. § 15-5-404, a trust "may be created only to the extent its purposes are lawful, not contrary to public policy, and possible to achieve."

Domestic Asset Protection Trusts ("DAPTs"): Background

- ▶ The common law and the laws of most states deny creditor protection to "self-settled" trusts in which the grantor is also a beneficiary.
- ▶ However, to attract business from off-shore jurisdictions that allowed for self-settled trusts, a growing number of states have passed laws allowing for DAPTs.
- ▶ Generally, DAPT states allow for the creation of a DAPT if the grantor says the transfer is not being done to hinder current or known creditors, will not make the grantor insolvent, and an in-state individual or entity is trustee.

In re Cleopatra Cameron Gift Trust, 2019 SD 35 (2019)

- ▶ While not involving a DAPT, the history of the Cleopatra Cameron Gift Trust (“Gift Trust”) illustrates the power of state creditor protection laws.
- ▶ Cleopatra Cameron and her husband divorced in California.
- ▶ A provision of California law allowed the California court to direct the trustee of the Gift Trust to distribute spousal and child support maintenance payments directly to the ex-husband.
- ▶ The administrative situs of the Gift Trust was moved to South Dakota, which prohibits distributions from trusts with spendthrift provisions to be made in support of spousal or child support obligations.
- ▶ The Supreme Court of South Dakota held that the trustee could not be compelled to make the payments.

DAPTs in Action: The Tale of Ed and Marie Bosarge

- ▶ Ed and Marie Bosarge are married in Texas in 1989 and have little wealth at first.
- ▶ The couple continue to reside in Houston and Ed eventually founded Quintlab, a high-speed trading firm. The couple's wealth increased exponentially as a result.
- ▶ Ed begins moving assets to off-shore trusts and eventually to South Dakota DAPTs. Initially, Marie is a beneficiary of these trusts, but Ed has them decanted into other DAPTs. (South Dakota law doesn't require notice to the beneficiaries.)
- ▶ Ed gets a mistress, but Marie thinks he would never divorce her because Texas is a community property state and they had no pre-marital agreement.
- ▶ Ed files for divorce in 2017.
- ▶ Marie's attorneys are frustrated by South Dakota's privacy laws, which allow for so-called "quiet trusts" that may remain entirely unknown to the beneficiary. Marie's attorneys face a quandary. The South Dakota DAPTs were likely funded with community property, but without the trust agreements and trust accountings, they have no way of knowing for certain.
- ▶ Ed and Marie eventually reach an out-of-court settlement.

Attacking a DAPT: Strategies for Colorado Family Lawyers

- ▶ Choice of Law: Colorado law is clear that self-settled trusts cannot be used to defeat creditors' claims.
- ▶ Fraudulent Transfer: Did the transfer violate Colorado's Uniform Fraudulent Conveyance Act? See C.R.S. § 38-8-105(1)(a) (transfers "with the actual intent to hinder, delay, or defraud any creditor" are invalid as to present and future creditors).
- ▶ In rem jurisdiction: If the assets in the DAPT are real property located in Colorado, then arguably Colorado law applies to these assets.
- ▶ Trust Administration: The grantor has retained too much control over the assets, the trustee may not be adhering to all the requirements of the DAPT statute, and/or the trustee may not be exercising control over the assets.

Questions?