

HOW TO PROTECT TRUST ASSETS FROM A BENEFICIARY'S DIVORCE

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How To Protect Trust Assets From a Beneficiary's Divorce
(A 2006 case and Trust Code Amendment illustrate
the issues surrounding this confusing area.)

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I. Introduction

Due to today's high divorce (dissolution of marriage) rate, clients place a high priority on protecting a child's inheritance from a potential divorce. Many attorneys assume that assets left to a beneficiary by gift or inheritance are automatically protected from divorce. Unfortunately, this is a tricky area of law, especially when dealing with interests in trusts.

This area of law is important in two contexts. When preparing an estate plan, the attorney is often asked to leave assets to children in trusts that will provide maximum protection in the event of a divorce. Second, at the time of divorce the attorneys for each spouse will fight to classify the assets as marital or nonmarital property. This classification is important as the court only has the authority to divide marital property. With respect to trusts, determining whether the beneficiary's interest in the trust is marital property depends on the terms of the trust, including whether the Trustee is required to distribute property to the beneficiary or whether distributions are at the discretion of the Trustee. Whether the beneficiary's interest is marital property also depends on whether the beneficiary has the unilateral right to withdraw the trust assets. This has been a complicated area in every state where it has arisen.¹

This article analyzes the current state of law in Missouri on whether a beneficiary's interest in an irrevocable trust is separate or marital property for purposes of the marital property division upon dissolution of marriage. The Missouri Uniform Trust Code (MUTC), enacted in 2006, is a comprehensive body of law providing an almost complete set of trust laws.² The MUTC did not originally address whether interests in trust were marital property upon divorce. However, a 2006 amendment to the MUTC enacted a new law that provides certainty in this area if the trust falls within a safe harbor. However, a 2006 case decided before the MUTC amendment murky up the waters a bit for trusts that do not fall within this safe harbor. The analysis below applies only to irrevocable trusts. The typical trust created as a will substitute, is a revocable trust, and for dissolution of marriage purposes the revocable trust property is treated as owned directly by the person who created the trust (the grantor or settlor).³ However, after the death of the

¹ Generally, for the treatment of trusts for dissolution of marriage purposes, see Marc A. Chorney, *Interests In Trusts As Property In Dissolution Of Marriage: Identification And Valuation*, 40 *Real Property, Probate and Trust Journal* 2 (Spring 2005); Michael Diehl, *The Trust In Marital Law: Divisibility of a Beneficiary Spouse's Interest On Divorce*, 64 *Tex. L. Rev.* 1301 (April 1986); W. Michael Wiist, *Trust Income: Separate Or Community?*, 51 *Baylor L. Rev.* 1149 (Fall 1999); Lisa H. Jamieson, *Marital Property Issues in the Modern Estate Plan*, 49 *Baylor L. Rev.* 391 (Spring 1997); *Divorce Property Distribution: Treatment And Method Of Valuation Of Future Interest In Real Estate Or Trust Property Not Realized During Marriage*, 62 *ALR* 4th 107 ; *Divorce Property Distribution: Real Estate Or Trust Property In Which Interest Vested Before Marriage And Was Realized During Marriage*, 60 *ALR* 4th 217; J. Thomas Oldham, *Divorce, Separation and The Distribution of Property* (1987).

² See Mo. Rev. Stat. section 456.1-101 et seq.

³ *Maninger v. Maninger*, 106 S.W.3d 4 (Mo. Ct. App. 2003).

grantor the trust becomes irrevocable. Many other types of irrevocable trusts are created for estate/gift tax, creditor protection, and control reasons.

II. Basic Rules

In a dissolution of marriage proceeding, the court is to divide all of the marital property in such proportions as the court deems just after considering the relevant factors.⁴ Marital property is all property acquired by either spouse after the marriage except:⁵

- (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;
- (4) Property excluded by valid written agreement of the parties; and
- (5) The increase in value of property acquired prior to the marriage or pursuant to subdivisions (1) to (4) of this subsection, unless marital assets including labor, have contributed to such increases and then only to the extent of such contributions.

The exception for property acquired by gift under paragraph (1) above, also applies to gifts between spouses.⁶ This means that a gift from wife to husband will be nonmarital property in the hands of the husband, and the wife has lost all of her rights to the property upon divorce. However, transfers between spouses solely for estate planning purposes will not qualify for this exception, so that the property transferred may still be marital property.⁷

The most important principle for purposes of this article is that income earned during a marriage from nonmarital property is marital property.⁸ Determining whether the income earned on trust property falls within this rule can be difficult. A comprehensive set of rules for determining what is trust income and what is trust principal, is contained in the Missouri Principal and Income Act. However, these rules do not apply to the determination of what is income for purposes of a marital property division. Income for dissolution of marriage purposes is determined by caselaw and the MUTC amendment described herein.

III. Problems With Outright Gifts and Bequests

If assets are left to a beneficiary outright, the assets received by the beneficiary will be protected from a marital property division, as assets acquired by gift or bequest, or as assets acquired prior

⁴ Mo. Rev. Stat. section 452.330.1.

⁵ Mo. Rev. Stat. Section 452.330.2.

⁶ *Townsend v. Townsend*, 705 S.W.2d 595 (Mo. Ct. App. 1986).

⁷ *Brady v. Brady*, 39 S.W.3d 557 (Mo. Ct. App. 2001).

⁸ *Kauffman v. Kauffman*, 101 S.W.3d 35 (Mo. Ct. App. 2003).

to marriage. However, during marriage the income from the assets will be marital property, and a spouse may argue that the appreciation is also marital property (if marital assets or labor contribute to the increase in value).

For example, consider Client, whose revocable trust provides that upon Client's death all assets will be distributed outright to Client's children in equal shares. If each child receives \$100,000, then that \$100,000 is nonmarital property as property acquired by bequest. If Child invests the \$100,000 in stock that pays a \$1,000 dividend, the \$1,000 is marital property. If Child purchases a home with the \$100,000 and Child's spouse spends weekends fixing it up to be resold, then the appreciation in the value of the home may be marital property as marital labor contributed to the increase.

Another problem with leaving assets to a beneficiary outright is that the assets are often commingled with marital assets. If Child takes the \$100,000 received from Client's revocable trust and puts it in a brokerage account containing money earned during marriage, then the inheritance has been "commingled" with marital property. Although commingling does not transmute nonmarital property into marital property, if there is no way to trace what is nonmarital property, it is difficult to overcome the statutory presumption that property acquired during the marriage is marital property.⁹ In addition, when a spouse titles nonmarital property in the joint names of both spouses, it raises a rebuttable presumption that the property was transmuted into marital property.¹⁰ Subject to conflict of interest limitations, attorneys should counsel clients on the divorce implications of commingling or jointly titling inherited property.

To avoid these problems altogether, clients should consider transferring property to family members in a discretionary lifetime trust, not outright, as described in more detail below. If property is held in trust, then it cannot be titled in joint name or commingled with marital property, assuming the spouse does not contribute his own assets to the trust (which should be avoided due to adverse tax and creditor protection consequences). In addition, as explained below the income of a discretionary trust is not marital property.

IV. Trust Principal

The amount initially used to fund a trust is "principal". Interest, dividends and rents earned on the principal are "income", but the realized or unrealized increase in value of the principal retains its character as principal. Trust principal is not marital "property", as the beneficiary has no "property" right in the principal of the trust, unless the beneficiary has the right to withdraw the trust assets.¹¹ If a beneficiary may withdraw trust assets, the principal will still be nonmarital property as property acquired by gift or bequest (or property acquired prior to marriage). However, a spouse could argue that the appreciation on the principal is marital property if the

⁹ Mo. Rev. Stat. Sections 452.330.3 and 452.330.4.

¹⁰ *Selby v. Selby*, 149 S.W.3d 472 (Mo. Ct. App. 2004).

¹¹ See *Moore v. Moore*, 111 S.W.3d 530 (Mo. Ct. App. 2003, Southern District) (a beneficiary is deemed to have acquired the underlying assets of the trust at such time as he has the ability to withdraw the trust assets).

spouse was a trustee or in some other way contributed to the appreciation.¹² Whether the trust income will be marital property is analyzed in the remainder of this article.

Consider Client, whose revocable trust left \$100,000 to Child in trust. The terms of the trust provide that the trustee may distribute the income and principal to Child for health, maintenance and education, for Child's entire lifetime. The \$100,000 owned by the trust is not marital or nonmarital property to Child. Child does not own the \$100,000, so he has no "property" that can be classified as marital or nonmarital. The only thing Child owns is the right to distributions from the \$100,000 (and income and appreciation thereon) at the discretion of the trustee.

V. Income From Discretionary Interests in Trusts

Missouri law now distinguishes between mandatory and discretionary interests in trusts. The following new law, part of the MUTC technical amendments, became effective August, 2006:¹³

A beneficiary's interest in a trust that is subject to the trustee's discretion does not constitute an interest in property even if the discretion is expressed in the form of a standard of distribution or the beneficiary is then serving as a trustee or co-trustee.

This law applies to preexisting trusts.¹⁴ The Missouri Comment to this new law states that "[t]his section was also altered to clearly state present Missouri law that discretionary interests in trusts are not property for any purposes, including dissolution of marriage."¹⁵

A beneficiary's interest is "subject to the trustee's discretion" if it is not a "mandatory distribution."¹⁶ A mandatory distribution is a "distribution of income or principal which the trustee is required to make to a beneficiary under the terms of the trust, including a distribution upon termination of the trust."¹⁷ "The term does not include a distribution subject to the exercise of the trustee's discretion even if (1) the discretion is expressed in the form of a standard of distribution, or (2) the terms of the trust authorizing a distribution couple language of discretion with language of direction."¹⁸

As a beneficiary's discretionary interest is not "property," then there can be no income from nonmarital "property" that becomes marital property (if there is a right of withdrawal this analysis may not apply, as explained below). Therefore, if all distributions are subject to the trustee's discretion, then neither accumulated nor distributed income will be marital property. Distributed income or principal will be nonmarital property as property acquired by gift or bequest. After a distribution to a beneficiary, future income on the assets now owned by the beneficiary will be marital property.

¹² Mo. Rev. Stat. Section 452.330.2(5).

¹³ Mo. Rev. Stat. Section 456.5-504.1.

¹⁴ Mo. Rev. Stat. Section 456.11-1106.1(1).

¹⁵ See Scot W. Boulton, Chapter 456 Missouri Revised Statutes Including the Missouri Uniform Trust Code With the 2006 Technical Corrections (the red book), published by the Missouri Bar Probate and Trust Committee.

¹⁶ Mo. Rev. Stat. Section 456.5-504.4.

¹⁷ Mo. Rev. Stat. Section 456.5-506.1.

¹⁸ Mo. Rev. Stat. Section 456.5-506.1.

Consider Client, whose revocable trust provides that upon Client's death all assets are left in trust for Client's Child, and the trust is funded with \$100,000. The terms of the trust provide that the trustee may distribute the income and principal to Child for health, maintenance and education, for Child's entire lifetime. If the trustee invests the \$100,000 in stock that pays a \$1,000 dividend, the \$1,000 is nonmarital property, notwithstanding whether the \$1,000 is retained in the trust or distributed outright to Child. "Health, maintenance, and education" is a discretionary standard, so the beneficiary has no "property" interest for divorce purposes. If the Trustee distributes the \$1,000 to the children outright, then the \$1,000 is nonmarital property, as property acquired by gift or bequest. However, if Child invests the \$1,000 in a bank account that earns \$50 of interest, then the \$50 will be marital property.

VI. All Income and Other Mandatory Distribution Standards

The new law explained above does not apply to mandatory distributions. The most common mandatory distribution is an all income requirement (i.e. the trustee must distribute "all" of the net income to the beneficiary at least annually). Other mandatory distributions include dollar amount distributions (distribute \$1,000 to the beneficiary) and percentage distributions (distribute 5% of the trust to the beneficiary).

Mandatory distributions are subject to existing case law. Two Missouri cases have considered whether trust income is marital property.

Moore 1 (right to withdraw trust assets caused future income to be marital property). A 2003 case ("Moore 1") found that a husband constructively received the trust assets at age 35, when he obtained the right to terminate the trust.¹⁹ The court found the undistributed income earned on the trust assets after husband's 35th birthday was marital property. The court did not discuss whether accumulated or distributed income was marital property before husband turned 35. The court focused on the date husband constructively acquired the assets of the trust, possibly because the husband's interest in the trust was not "property" before he obtained the right to terminate the trust. The court based its holding on several cases from Texas and Pennsylvania and a treatise. These cases stand for the general rule that trust income is not marital property unless the beneficiary has the right to withdraw the trust property.

Moore 2 (distributed income was marital property even without right of withdrawal). A 2006 case ("Moore 2") analyzed a similar issue.²⁰ In Moore 2, wife was the beneficiary of two trusts created by her parents. Wife was entitled to all of the net income, quarterly, and principal for maintenance, support, health or education. The court held that distributions of trust income to wife were marital property, as income earned on nonmarital property. Wife was sole income beneficiary, sole Trustee and she reported the trust income on her personal income tax return. The court equated the wife's control over the trust with the right to terminate the trust that was present in Moore 1. This reasoning is flawed. Clearly the right to terminate a trust or withdraw the assets is tantamount to owning the trust property directly. The fact that a person is the sole

¹⁹ *Moore v. Moore*, 111 S.W.3d 530 (Mo. Ct. App. 2003, Southern District).

²⁰ *Moore v. Moore*, 189 S.W.3d 627 (Mo. Ct. App. 2006, Western District).

income beneficiary, sole trustee and reports the income as is required by the tax law is completely different, and does not give a beneficiary anywhere near the control of a right of withdrawal.

Other Cases Support Moore 1

Additional cases from Texas and Colorado that were not cited in Moore 1 also support the notion that a mandatory interest is not "property" unless the beneficiary has the right to withdraw the trust property.²¹

Hopefully subsequent Missouri law will make clear that mandatory distributions are not marital property. Until then care should be taken drafting new trusts and planning for distributions from existing irrevocable trusts with mandatory distribution standards, as explained below.

VII. Rights of Withdrawal

If a beneficiary has the right to withdraw trust assets a court may find that both accumulated and distributed income is marital property, notwithstanding whether the distribution standard is discretionary or mandatory. In other words, it is unclear whether the MUTC amendment discussed above overrules Moore 2 if the beneficiary has the right to withdraw the trust assets.

VIII. Self-Settled Trusts

It is also unclear whether the MUTC amendment applies to self-settled irrevocable trusts. A self-settled trust "as opposed to a third party trust" is one in which the beneficiary contributed his own assets to the trust. The MUTC amendment expressly applies to "[a] beneficiary's interest in a trust" and does not exclude self-settled trusts. Even if the MUTC amendment does not apply to self-settled trusts, Moore 1 is authority for the proposition that trust income "whether or not the trust is self-settled" is not marital property, unless the beneficiary can withdraw the trust assets.

For example, Client creates an irrevocable trust for asset protection purposes, whereby the trustee may distribute the income and principal to Client in the trustee's sole discretion. Client

²¹ In re the Marriage of Guinn, 93 P.3d 568 (Colo. Ct. App. 2004) ("In the absence of some ownership interest in the corpus itself, we conclude that even a mandatory right to unrealized future discretionary allocations of income is an expectancy arising from the largess of the settlors and does not constitute property"); Cleaver v. Cleaver, 935 S.W.2d 491 (Tex. App. 1996) ("Wife's income from the trust is her separate property because her interest was established before her marriage and was conveyed by gift or devise."); Wilmington Trust Company v. The United States, 83-USTC ¶13547 (US Claims Ct 1983) ("the income derived during the marriage constituted the separate property of Mrs. Asche. Mrs. Asche never acquired it and she will never acquire it the corpus of any of these trusts."); Also see Michael Diehl, The Trust In Marital Law: Divisibility of a Beneficiary Spouse's Interest On Divorce, 64 Tex. L. Rev. 1301 (April 1986) ("Income from a trust in which the beneficiary has no right to invade corpus should be treated as the intended gift or bequest of the settlor; as such, the income should be regarded as separate, nonmarital, or individual property."); Noel C. Ice, Is Trust Income Community?, (If it is conceded that a spouse's beneficial interest in a trust was acquired by gift (and is therefore separate property), it does not follow that the income produced by the trust is income from the beneficial interest: the income is the beneficial interest.) available at http://www.trustsandestates.net/Marital_Property/Ice_Trust_Inc_Is_SepProp.rtf.

funds the trust with \$100,000 of Client's separate property earned prior to marriage. If the \$100,000 is held in a bank account that earns \$500 of income, the \$500 should be nonmarital property (whether accumulated or distributed) as distributions are subject to the trustee's discretion and Client cannot withdraw the trust assets.

IX. Contingent Remainder Interests in Trusts

If a beneficiary is not a permissible distributee of income or principal, but has only an expectancy as a future contingent beneficiary, then the beneficiary has no "property" interest in the trust for divorce purposes. Even if the beneficiary's rights are considered property, they will be excluded from marital property as property acquired by gift of bequest (or acquired prior to marriage).

Consider Client who creates a revocable trust that provides that all trust property passes outright to Child upon Client's death. While Client is alive, Child has only an expectancy as a future contingent beneficiary. Client may amend or revoke the trust, so Child may never receive anything from the trust. This expectancy is not marital property. Or consider an irrevocable trust created for Child by Parent, where the trustee may distribute income and principal to Child for health, education and support. Upon Child's death, the remaining assets pass to Grandchild outright. It is unclear whether Grandchild has a "property" right as the contingent remainder beneficiary. Even if Grandchild's remainder interest is a property interest, that property interest is nonmarital property as it was acquired by gift from Parent.

X. Planning Opportunities (Using Lifetime Trusts)

Third Party Trusts. Attorneys should counsel clients that assets, and the income thereon, left to a beneficiary in a lifetime trust with a discretionary principal and income standard (i.e. the trust does not require all of the income to be distributed) will not be marital property. It is important that the trust last for the beneficiary's lifetime and that the beneficiary not have a right of withdrawal. At the age the client would like the beneficiary to have control of the trust, the beneficiary can serve as sole Trustee without adverse divorce consequences. If all distributions are subject to the Trustee's discretion, then neither income nor principal, whether accumulated or distributed, will be marital "property", as the beneficiary's interest is not "property".²² It may also be beneficial to state the grantor's intent that all property of the trust and all distributions, whether of income or principal, are intended to be nonmarital property. Although this may not be important in Missouri, if a beneficiary is subject to a divorce proceeding in another state, it may prove helpful.²³ Keep in mind that Missouri law will only apply to the marital/nonmarital property issue if the spouse files for divorce in Missouri. A choice of law clause in the trust agreement will most likely be ineffective to guarantee Missouri law will be applied to this issue.

²² Mo. Rev. Stat. Section 456.5-504.1.

²³ Michael Diehl, The Trust In Marital Law: Divisibility of a Beneficiary Spouse's Interest On Divorce, 64 Tex. L. Rev. 1301 (April 1986); W. Michael Wiist, Trust Income: Separate Or Community?, 51 Baylor L. Rev. 1149 (Fall 1999).

Self-Settled Trusts. If a client wants to protect his own property from divorce, the best tool is a premarital agreement that explicitly addresses interests in trusts. However, for situations in which there will not be a premarital agreement, it appears that in Missouri you may contribute your own assets to a discretionary irrevocable trust and protect the trust income and principal from being marital property, as long as you do not have the right to withdraw the trust assets.

Existing Irrevocable Trusts. The beneficiary of an existing irrevocable trust with a mandatory interest should consider holding any income distributed to him/her in a separate account with no other assets to avoid commingling the distributed income with nonmarital property, in the event it is determined that such distributed income was marital property. Also, a beneficiary may consider modifying an irrevocable trust to maximize the divorce protection.²⁴

XI. Conclusion

The analysis above provides the following conclusions:

- Neither distributed nor undistributed trust principal is marital property.
- Undistributed trust income is not marital property, unless the beneficiary has the right to withdraw the trust assets.
- Income distributed to a beneficiary pursuant to the Trustee's discretion is nonmarital property.
- Pursuant to a 2006 case, a mandatory distribution of income may be marital property, even if the beneficiary has no right to withdraw the trust assets.

As a final note, when drafting wills, revocable trusts, and irrevocable trusts, remember that it is important to educate the client on the divorce protection benefits of lifetime trusts.

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²⁴ See Mo. Rev. Stat. Sections 456.4-411A and 456.4-411B.