

Article

A Beneficiary Serving as Trustee May Affect Asset Protection

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Naming a trust beneficiary as the sole trustee of a trust can endanger the protection that trust assets generally have from the beneficiary's creditors, unless the trustee's distribution discretion is limited.



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Clients with asset-protection goals often favor the use of a discretionary lifetime trust for a beneficiary. Unlike a trust with mandatory distributions at specific ages or events, a discretionary lifetime trust can provide creditor protection for the beneficiary's life. Generally speaking, assets maintained within a trust cannot be reached by a beneficiary's creditors, while trust assets distributed to a beneficiary can be reached by the beneficiary's creditors.

Clients also favor the use of a lifetime trust on learning that the trust can purchase property for the beneficiary's use instead of distributing assets to the beneficiary to purchase the property. For example, if a beneficiary of a trust desires to purchase a home, the trustee could purchase the home for the beneficiary instead of distributing funds to the beneficiary to enable the beneficiary to purchase the home.

Primary Beneficiary as Sole Trustee

When considering a discretionary lifetime trust, clients often ask whether the primary beneficiary of that trust can become its sole trustee, which would mirror the control the beneficiary would have if the beneficiary had received all of the trust assets outright. This goal can be achieved by inserting a provision in the trust instrument that describes the process for a beneficiary to become sole trustee.¹

Creditor protection at risk. When a beneficiary of a trust becomes sole trustee of that trust, creditor protection for the beneficiary can be put at risk. Restatement (Third) of Trusts² highlights this issue and discusses the applicable rule as follows:

Sometimes a beneficiary is trustee of the discretionary trust, with authority to determine his or her own benefits. In such a case, a rule similar to that ... [for self-settled trusts] applies, with creditors able to reach from time to time the maximum amount the trustee-beneficiary can properly take. As in other nonsettlor-beneficiary situations, the court may reserve a portion of that amount for the

beneficiary's actual needs for reasonable support, health care, and education.... The beneficiary's rights and authority represent a limited form of ownership equivalence analogous to certain general powers...; thus, the rule of this Comment is similarly unaffected by a purported spendthrift restraint....³

Two illustrations regarding the rule above are supplied in the Restatement (Third) of Trusts:

9. S's will leaves his residuary estate to his daughter D, as trustee, "to pay income or principal to or for the benefit of any one or more of D, her children, and their issue in such amounts, if any, as the trustee deems appropriate and desirable for the particular beneficiary's support, education, and care, taking account of the beneficiary's other resources if and to whatever extent the trustee deems appropriate." D's creditors may reach the maximum amount of trust funds that she may, without abuse of her discretion, distribute to herself for the authorized purposes...., without reduction for other resources available to her for those purposes, but subject to a possible reservation the court may make for D's actual support needs.

10. The facts are the same as in Illustration 9, except that T serves as co-trustee with D, and they together hold the discretionary power to determine trust distributions. The special rule of this Comment does not apply. The creditors may still attach D's interest, absent a spendthrift restraint, but under the general rule of this Section.⁴

Revisions to Restatement of Trusts. The rule and illustrations above have no counterparts in prior Restatements of Trusts, but they were addressed as a result of modern planning practices, decades of American experience under the general-power or virtual-ownership rules of the Internal Revenue Code, and certain case law.⁵ Furthermore, the rule above is separate and distinct from the doctrine of merger, which terminates a trust when the legal title to trust property and the entire beneficial interest become united in one person.⁶

The rule above was overlooked in the original version of the Uniform Trust Code ("UTC"),⁷ but was evaluated in the 2004 amendment to the UTC:

The UTC, as previously drafted, did not specifically address the issue of whether a creditor of a beneficiary may reach the beneficial interest of a beneficiary who is also a trustee. However, Restatement (Third) of Trusts §60, comment g, which was approved by the American Law Institute in 1999, provides that the beneficial interest of a beneficiary/trustee may be reached by the beneficiary/trustee's creditors. Because the UTC is supplemented by the common law (see UTC Section 106), this Restatement rule might also apply in states enacting the UTC. The drafting committee has concluded that adoption of the Restatement rule would unduly disrupt standard estate planning and should be limited. Consequently, Section 504 is amended to provide that the provisions of this section, which generally prohibit a creditor of a beneficiary from reaching a beneficiary's discretionary interest, apply even if the beneficiary is also a trustee or cotrustee. The beneficiary-trustee is protected from creditor claims to the extent the beneficiary-trustee's discretion is protected by an ascertainable standard as defined in the relevant Internal Revenue Code sections. The result is that the beneficiary's trustee's interest is protected to the extent it is also exempt from federal estate tax. The amendment thereby achieves its main purpose, which is to protect the trustee-beneficiary of a bypass trust from creditor claims.

The Code does not specifically address the extent to which a creditor of a trustee/beneficiary may reach a beneficial interest of a beneficiary/trustee that is not limited by an ascertainable standard.⁸

The amendment to UTC section 504 that was adopted in 2004 to address the rule above reads as follows:

(e) If the trustee's or cotrustee's discretion to make distributions for the trustee's or cotrustee's own benefit is limited by an ascertainable standard, a creditor may not reach or compel distribution of the beneficial interest except to the extent the interest would be subject to the creditor's claim were the beneficiary not acting as trustee or cotrustee.

Differences Among States

Exhibit 1 shows that 14 of the 23 states that have enacted the Uniform Trust Code have adopted UTC section 504(e) or substantially similar language. (Exhibit 2 supplies the substantially similar language adopted by 12 of those 14 states.) Thus, when drafting a trust that will be governed by the law of one of those 14 states, it is prudent for asset-protection purposes to

EXHIBIT 1 UTC States' Treatment of UTC section 504(e)

State	Adopted section or substantially similar language?	Adopted section 504(e)?	Adopted other language?	Citation
Alabama	Yes	No	Yes	Ala. Code sec. 19-3B504(e)
Arizona	Yes	No	Yes	Ariz. Rev. Stat. 14-10504(e)
Arkansas	Yes	No	Yes	Ark. Code Ann. sec. 28-73-504(c)
Florida	Yes	Yes	No	Fla. Stat. sec. 736.0504(3)
Maine	Yes	No	Yes	Me. Rev. Stat. Ann. Tit. 18-B, sec. 504(3)
Missouri	Yes	No	Yes	Mo. Rev. Stat. sec. 456.5-504
Nebraska	Yes	No	Yes	Neb. Rev. Stat. sec. 30-3849(e)
New Hampshire	Yes	No	Yes	N.H. Rev. Stat. Ann. sec. 564-B:5-504(e)
North Carolina	Yes	No	Yes	N.C. Gen Stat. sec. 36C-5-504(f)
North Dakota	Yes	Yes	No	N.D. Cent. Code sec.59-13-04(5)
Ohio	Yes	No	Yes	Ohio Rev. Code Ann. sec. 5805.04(F)
South Carolina	Yes	No	Yes	S.C. Code Ann. sec. 62-7-504(f)
Tennessee	Yes	No	Yes	Tenn. Code Ann. sec.35-15-504(c)
Virginia	Yes	No	Yes	Va. Code Ann. sec. 55-545.04
District of Columbia	No	No	No	
Kansas	No	No	No	
Michigan	No	No	No	
New Mexico	No	No	No	
Oregon	No	No	No	
Pennsylvania	No	No	No	
Utah	No	No	No	
Vermont	No	No	No	
Wyoming	No	No	No	

EXHIBIT 2
UTC States' Treatment of UTC section 504(e)

Alabama — Omits UTC section 504(e), but includes its own similar language:

"A creditor may not reach the interest of a beneficiary who is also a trustee or co-trustee, or otherwise compel a distribution, if the trustee's discretion to make distributions for the trustee's own benefit is limited by an ascertainable standard." Ala. Code sec. 19-3B-504(e).

Arizona — Omits UTC section 504(e), but includes its own similar language:

"A creditor of a beneficiary, whether or not the beneficiary is also a trustee or cotrustee, may not reach the beneficiary's beneficial interest or otherwise compel a distribution if either the trustee's discretion to make distributions for the trustee's own benefit is purely discretionary or is limited by an ascertainable standard, including a standard relating to the beneficiary's health, education, support or maintenance or similar language within the meaning of section 2041(b)(1)(a) of the internal revenue code." Ariz. Rev. Stat. sec. 14-10504(e).

Arkansas — Omits UTC section 504(e), but includes its own similar language:

"A creditor may not reach the interest of a beneficiary who is also a trustee or cotrustee, or otherwise compel a distribution, if the trustee's discretion to make distributions for the trustee's own benefit is limited by an ascertainable standard." Ark. Code Ann. sec. 28-73-504(c).

District of Columbia — Omits section 504 in its entirety.

Florida — Includes section 504(e) as Fla. Stat. sec. 736.0504(3).

Kansas — Omits section 504 in its entirety.

Maine — Omits section 504(e), but includes its own similar language:

"Creditor limited. A creditor may not reach the interest of a beneficiary who is also a trustee, or otherwise compel a distribution, if the trustee's discretion is limited by an ascertainable standard." Me. Rev. Stat. Ann. tit. 18-B, sec. 504(3).

Missouri — Omits section 504(e), but includes its own similar language:

"A beneficiary's interest in a trust that is subject to the trustee's discretion does not constitute an interest in property or an enforceable right even if the discretion is expressed in the form of a standard of distribution or the beneficiary is then serving as a trustee or cotrustee. A creditor or other claimant may not attach present or future distributions from such an interest or right, obtain an order from a court forcing the judicial sale of the interest or compelling the trustee to make distributions, or reach the interest or right by any other means, even if the trustee has abused the trustee's discretion." Mo. Rev. Stat. sec. 456.5-504(1)

Michigan — Omits section 504(e).

Nebraska — Omits section 504(e), but includes its own similar language:

"A creditor may not reach the interest of a beneficiary who is also a trustee or cotrustee, or otherwise compel a distribution, if the trustee's discretion to make distributions for the trustee's own benefit is limited by an ascertainable standard." Neb. Rev. Stat. sec. 30-3849(e).

New Hampshire — Omits section 504(e), but includes its own similar language:

"Creditor or assignee of a beneficiary may not compel a distribution to the beneficiary solely because the beneficiary is a trustee if the beneficiary-trustee does not have the discretion to make or participate in making distributions to himself or herself, if the beneficiary-trustee's discretion to make or participate in making distributions to himself or herself is limited by an ascertainable standard, or if the beneficiary-trustee's discretion to make or participate in making distributions to himself or herself is exercisable only with the consent of a cotrustee or another person holding an adverse interest. Under such circumstances, the creditor or assignee may compel a distribution only to the extent the creditor or assignee otherwise may compel a distribution were the beneficiary not acting as trustee or cotrustee." N.H. Rev. Stat. Ann. sec. 564-B:5-504(e).

New Mexico — Omits section 504(e).

North Carolina — Omits section 504(e), but includes its own similar language:

"Creditor may not reach the interest of a beneficiary who is also a trustee or cotrustee, or otherwise compel a distribution, if the trustee's discretion to make distributions for the trustee's own benefit is limited by an ascertainable standard." N.C. Gen. Stat. sec. 36C-5-504(f)

North Dakota — Includes section 504(e) as N.D. Cent. Code sec. 59-13-04(5).

Ohio — Omits section 504(e), but includes its own similar language:

"If the trustee's or cotrustee's discretion to make distributions for the trustee's or cotrustee's own benefit is limited by an ascertainable standard, a creditor may not reach or compel distribution of the beneficial interest except to the extent the interest would be subject to the creditor's claim if the beneficiary were not acting as trustee or cotrustee." Ohio Rev. Code Ann. sec. 5805.04(F).

Oregon — Omits section 504 in its entirety.

Pennsylvania — Omits section 504(e).

South Carolina — Omits section 504(e), but includes its own similar language:

“creditor of a beneficiary who is also a trustee or cotrustee may not reach the trustee’s beneficial interest or otherwise compel a distribution if the trustee’s discretion to make distributions for the trustee’s own benefit is limited by an ascertainable standard.” S.C. Code Ann. sec. 62-7-504(f).

Tennessee — Omits section 504(e), but includes its own similar language:

“If the trustee’s or co-trustee’s discretion to make distributions for the trustee’s or co-trustee’s own benefit is limited by an ascertainable standard, a creditor may not reach or compel distribution of the beneficial interest except to the extent the interest would be subject to the creditor’s claim were the beneficiary not acting as trustee or co-trustee.” Tenn. Code Ann. sec. 35-15-504(c).

Utah — Omits section 504(e).

Vermont — Omits section 504(e).

Virginia — Omits section 504(e), but includes its own similar language:

“A creditor may not reach the interest of a beneficiary who is also a trustee or cotrustee, or otherwise compel a distribution, if the trustee’s discretion to make distributions for the trustee’s own benefit is limited by an ascertainable standard.” Va. Code Ann. sec. 55-545.04.

Wyoming — Omits section 504(e).

insert language limiting a trustee’s discretion to make distributions for the trustee’s own benefit by an ascertainable standard such as health, education, maintenance, and support.

For the nine UTC states that have not adopted UTC section 504(e) or substantially similar language, creditor protection for a beneficiary-trustee will be determined over time by common law. Some of those states replaced the creditor protection rules in Article V of the UTC with the creditor protection rules from the Restatement (Second) of Trusts. Such action may have an impact on common law development of creditors’ rights in those states with respect to a trustee-beneficiary.

While the Comment to UTC section 504(e) provides that the UTC does not specifically address the extent to which a creditor of a trustee-beneficiary may reach a beneficial interest of the trustee-beneficiary that is not limited by an ascertainable standard,⁹ it also warns that a state’s adoption of the UTC may also result in the state’s adoption of the rule in the Restatement (Third) of Trusts that a creditor can reach from time to time the maximum amount a trustee-beneficiary can properly take.¹⁰ That warning could also be considered for a trust governed by the law of a state that has not adopted the UTC because the common law discussed in the Restatement (Third) of Trusts regarding the rights of a creditor of a trustee-beneficiary might expand over time to the common law in those states.¹¹

Drafting Suggestions

In summary, the following drafting suggestions are offered when clients desire to have a

beneficiary of a trust serve as trustee of that trust:

- If the trust is governed by the law of a state that has adopted UTC section 504(e) or substantially similar language, a trustee-beneficiary will have creditor protection if the distribution power exercisable in favor of the trustee-beneficiary is limited to ascertainable standards.
- If the trust is governed by the law of a state that has not adopted UTC section 504(e) or substantially similar language, then, until the common law of that state develops further, the trustee-beneficiary should have creditor protection if:
 - (1) The trustee-beneficiary serves as co-trustee with a third party.
 - (2) The trustee-beneficiary is not the only current beneficiary of that trust.
 - (3) The distribution power exercisable in favor of the trustee-beneficiary is limited to ascertainable standards.¹²

If the trustee-beneficiary is or becomes sole trustee of a trust governed by the law of a state that has not adopted UTC section 504(e) or substantially similar language, the trustee-beneficiary should consider resigning (as opposed to releasing either the discretionary distribution power or the discretionary interest) if he or she experiences creditor problems, but the resignation should occur before a creditor attaches the trustee-beneficiary’s interest in the trust.

Resigning is recommended as opposed to releasing either the discretionary distribution power or the discretionary interest because

the Restatement (Third) of Trusts advises that a trustee-beneficiary's rights and authority represent a limited form of ownership equivalence analogous to certain general-powers or virtual-ownership rules for income, gift, and estate tax purposes. When so construed, the release of the discretionary distribution power or the discretionary interest might be a transfer in fraud of creditors, reachable by the creditor of the trustee-beneficiary.¹³ Thus, the resignation alternative may prove to be the best alternative under the circumstances, assuming resignation is not treated as a release of the discretionary distribution power and the trustee-beneficiary cannot reappoint himself or herself as trustee. ■

1. The primary beneficiary often starts off as a co-trustee and later becomes the sole trustee.
2. RESTATEMENT (THIRD) OF TRUSTS (ALI 2003) ("Restatement (Third) of Trusts").
3. Restatement (Third) of Trusts, *supra* note 2, section 60, Comment g, at 412.
4. Restatement (Third) of Trusts, *supra* note 2, section 60, Comment g, Illustrations 9 and 10, at 413. The special rule of this Comment does not apply in Illustration 10 because the discretionary distribution power is held jointly with another person who has fiduciary duties to other beneficiaries of the trust. *Id.*
5. Restatement (Third) of Trusts, *supra* note 2, section 60, Comment g, Reporter's Notes, at 427-430. See, e.g., *In re McCoy*, 274 BR 751 (Bkrptcy, DC Ill., 2002) (where the trust assets there became part of the bankruptcy estate because the debtor, as sole trustee and primary life beneficiary, could invade the corpus of a spendthrift trust for any purpose and to any extent and at any time he deems "desirable," which invalidated the alleged spendthrift character of the trust); *In re Baldwin*, 142 BR 210 (Bkrptcy, DC Ohio, 1992) (where the debtor had the ability to exercise dominion and control over the trust by appointing herself as trustee, rendering the spendthrift provisions inoperable); and *Morrison v. Doyle*, 570 NW2d 692 (Minn. App., 1997), rev'd 582 NW2d 237 (Minn., 1998) (where the court of appeals held that the husband's beneficial interest was subject to attachment because he had discretion, as trustee, to distribute income and principal to himself as he saw fit).
6. Restatement (Third) of Trusts, *supra* note 2, section 69, Comments and Reporter's Notes, at 535-539. However, several cases have dealt with the situation where a life or remainder interest in part of the trust property comes together with all or part of the corresponding interest. Some of those cases have held that the trust can be terminated *pro tanto* as to that part of the corpus as to which the life and remainder interests have joined in the hands of one person. Shipley, Annotation, "Termination of Trust Where Life Interest and Remainder or Reversion Are Acquired By Same Person," 50 A.L.R.2d 1161 §7 (2010).
7. UNIFORM TRUST CODE (2000), 7C U.L.A 407 (2006) ("UTC").
8. UTC, *supra* note 7, Comment, at 531.
9. UTC, *supra* note 7, Comment, at 531.
10. *Id.*
11. See the cases discussed in note 5, *supra*.
12. Comments here regarding cotrusteeship and multiple trust beneficiaries were derived from Illustrations 9 and 10 to which note 4, *supra*, applies.
13. Restatement (Third) of Trusts, *supra* note 2, section 60, Comment g, at 412-413.