

Dude, I'm Your New Son-in-Law

May 2011 from James M. Kane, Attorney

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This newsletter is about family, particularly the adage “You can pick your friends, but you can’t pick your family”.

Bottom line, this is a recommendation for including both fully-discretionary trust provisions and HEMS provisions in the trust document. A fully-discretionary trust can make a world of difference with the level of asset protection for the trust property. This distinction (and what HEMS means) will make more sense as you read this newsletter.

As to family in the context of asset protection, for example, what is the potential reach of your new son-in-law into the property your daughter will get from your estate? [Or, a daughter-in-law as to your son.]

More specifically, will the estate property for your daughter be held in trust, or outright by her? If outright, will the estate property merely get commingled with your son-in-law’s property, thereafter giving him access, potential control, and a hand in those assets?

If in trust, are the operative provisions in the trust document sufficient to provide the greatest level of asset protection for your daughter, if ever needed? If the trust does not include fully-discretionary trust provisions, it is not.

It Simply Gets Down to a Choice

Whether to use trusts instead of outright distributions is a choice based on numerous factors, including the cost-benefit for setting up, maintaining and operating a trust, tax planning necessities, the beneficiaries’ lack of money experience or disregard of thriftiness, asset protection, occupational risks, divorce, or to

help maintain a nest-egg for rainy days.

There is no one-type-fits-all answer when considering the use and design of trusts. But, among the factors to consider, asset protection should be at the top of the list.

What is a HEMS Trust?

The acronym “HEMS” means health, education, maintenance and support. The trustee of a HEMS trust can make distributions to the beneficiaries based on the health, education, maintenance and support of the beneficiaries. The trustee does not have full discretion, as with a fully-discretionary trust.

Only HEMS Provisions?

Tax-driven estate planning documents often include only HEMS standards, without fully-discretionary trust provisions.

As a general rule, the tax law – for reasons I do not expand on in this newsletter – mandates HEMS standards whenever a family member or trust beneficiary is the trustee of the trust. This HEMS set-up for tax reasons is fine, and frequently typical.

But this tax-driven HEMS approach is not mutually exclusive with including also the fully-discretionary trust provisions within the trust document.

Why a Fully-Discretionary Trust?

A fully-discretionary trust is not governed by HEMS, but instead gives the trustee complete discretion as to whether, when, and how much the distributions from the trust will be to the beneficiaries.

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The fully-discretionary trust is virtually bullet-proof for asset protection purposes where a third party tries to force a distribution from the trust to satisfy a claim against a trust beneficiary.

For example, the IRS failed and was unsuccessful in trying to levy and foreclose its tax lien against the trust property of a fully-discretionary trust where the son (taxpayer) was a beneficiary under his mother's fully-discretionary trust. *U.S. v. Butler*, No. MO-08-CA-88-H, 2009 WL 1112795 (W.D. Tex. Feb. 17, 2009).

A fully-discretionary trust also greatly reduces third-parties who have, what the law calls, legal standing as "interested parties" to obtain an audience before a court in relation to the trust, such as to pursue accountings of the trust property, or to try and enforce third-party claims against the trust.

By contrast, a HEMS trust provides a lesser degree of asset protection for the trust property and its trust beneficiaries and is much more susceptible to a successful attack. It has also a much greater range of interested parties who have legal standing to force themselves into a dispute with the trust.

Independent vs. Non-Independent Trustees

Generally, the tax law requires HEMS provisions when a beneficiary or non-independent trustee is acting as trustee. Internal Revenue Code Section 672(c) defines a non-independent trustee as a beneficiary, related, or subordinate party who is subservient to the wishes of the person who created the trust.

By contrast, an independent trustee does not have to be limited to the HEMS standards. The independent trustee can hold fully-discretionary powers. An independent trustee is a trustee not meeting this definition of a non-independent trustee.

Dual-Trust Design

This dual-trust design includes trust provisions that give an independent trustee fully-discretionary powers; but, mandates HEMS provisions when the trustee is non-independent.

The trust beneficiary has also the power to remove and replace the trustee with or without cause,.

The HEMS mandate for a beneficiary/trustee or non-independent trustee is to prevent the IRS from treating the beneficiary -- if the beneficiary or non-independent trustee were otherwise allowed fully-discretionary powers -- as having a general power of appointment. For readers wanting a more technical discussion, review, for example, Treas. Reg. §20.2041-1(b)(1); Rev. Rul. 95-58; IRS Letter Rulings 200533007; 199909016; and 9607008.

Also for asset protection and tax law reasons, the beneficiary of this dual-design trust who removes and replaces the trustee with an independent trustee cannot thereafter toggle back and forth between the HEMS and fully-discretionary trust features. The beneficiary's from that point forward is limited only to removing and replacing independent trustees.

To illustrate this dual-design, a child's lifetime trust with HEMS provisions and the child as trustee is the initial set-up (thus, a non-independent trustee); but later, if necessary, the terms of the trust document can become operative by default to provide for a fully-discretionary trust with an independent trustee.

Assume the child above becomes an OB/GYN physician, and as a result of her occupational exposure, decides to trigger the greater asset protection that a fully-discretionary trust provides.

The child can resign and appoint a successor independent trustee subject to the fully-discretionary trust provisions, not HEMS. This dual-design provides optimal flexibility for the child and asset protection of the trust property.

As other examples, this default to a fully-discretionary trust can occur if the child finds herself on the pathway of a contentious divorce, or if she anticipates filing for bankruptcy.

Beyond the Academic re In-Law Divorces

I was involved in a divorce case where at issue was whether the trust and its value (this trust was created by the divorcing child's parents)

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could be taken into account by the jury during the divorce. The divorcing child's trust was a fully-discretionary trust with an independent trustee. We represented the trustees.

We successfully blocked the trust information from the jury. The jury could not, therefore, gain knowledge of the trust in setting alimony. I attribute the strength of our favorable outcome to the fully-discretionary trust provisions. The divorcing child's parents had included these protective features in the trust. Our position would have been significantly weaker, and potentially unwinnable, if this had been a HEMS trust.

Although the facts in every divorce case differ, the following two points under Georgia law touch on whether the other non-beneficiary spouse in a divorce can get his or her hands on a trust, or at least in front of a jury, pointing to the substantial importance of fully-discretionary trust provisions.

First, an independent trustee with full discretion cannot be forced to make a distribution from a trust in order to satisfy a divorce property settlement or for payment of alimony. Compare *Henderson v. Collins*, 245 Ga. 776, 779 (1980) (although not a divorce case, this court opinion refers to the proposition that a creditor cannot compel payment of principal or interest from the trustee "because the beneficiary could not himself compel such payments").

Two, with a HEMS trust (not fully-discretionary), whether the trustee can be forced to distribute trust funds to satisfy alimony gets gray. A strong argument against the trustee is that alimony is a support obligation. Support is a distribution standard under HEMS.

Thus, arguably a HEMS trust opens the door potentially for a successful claim against the trust for alimony and also may trigger the spendthrift clause exception under Georgia law allowing claims for alimony. O.C.G.A. §53-12-80(d)(1).

Negatives in Using the Dual-Trust Design?

To preface a response to this question, my view is that if you are going to incur the time and expense of using and maintaining trusts, the trusts should be designed with the greatest degree of asset protection (particularly as an option if ever necessary).

The primary factor some clients may perceive as a negative is, as discussed above, once a beneficiary exercises a trustee removal power and appoints an independent trustee, this power of removal and replacement will be limited thereafter to independent trustees.

Clients also may not be comfortable with a fully-discretionary power of a trustee. However, this can be addressed by including suggestions in the trust document (called "precatory language", not legally binding). For example, including precatory language in the trust document stating the independent trustee, in the trustee's discretion, may be liberal in making distributions to the beneficiary.

Or, including suggestions that the independent trustee may make distributions to the beneficiary with a preference over the interests of the remainder beneficiaries, etc. These precatory instructions will not, however, decrease the asset protective elements of a fully-discretionary trust.

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