Take-Away: Protecting a trust beneficiary's interest in a Trust in a divorce proceeding is becoming more and more difficult as states seem to ignore *separate property* principles. How a third-party Trust is drafted may provide some additional protection in the face of a divorce court's equitable distribution powers.

Background: Considering the scheduled *sunset* of the large applicable transfer tax exemption amounts on January 1, 2026, a lot of attention is given these days to lifetime gifts that consume the donor's available transfer tax exemption, either with lifetime transfers like outright gifts, or funding spousal lifetime access trusts (SLATs), or funding long-term dynasty trusts that are intended to consume the donor's lifetime generation skipping transfer tax (GSTT) exemption. With an irrevocable trust contemplated as part of an estate plan, some thought needs to go into adding trust terms to address the potential that a trust beneficiary might later find themselves in a divorce and the divorce court is fondling looking at the Trust to divide the marital estate more fairly. While this topic has regularly been covered in prior missives, it is good idea to revisit gifts and inherited property held in trust in light of the evolution of *separate* property in divorce proceedings. Some thoughts on how a Trust might be drafted in anticipation of a beneficiary's future divorce are covered below.

Michigan Law: Michigan's common law treats gifted or inherited property as the donee's *separate* property which is supposed to be excluded when a divorce judge makes an equitable distribution of the marital estate. That sounds good in theory, but reality is often an entirely different result.

> **Equitable Distribution:** First, while Michigan divorce courts are courts whose authority is confined by statute, the trial judge is ultimately charged with making an *equitable distribution* of the marital estate. This

charge to the divorce judge to make a *fair* division of the marital estate, with both spouse's access to wealth in mind, often leads to including gifted or inherited wealth, including interests in a trust, or *separate* property, and income from a trust, in making a division of wealth, or leaving that *separate* property in the name of its recipient, but awarding more of the marital assets to the spouse who was not the recipient of the gift or inheritance, indirectly accomplishing what *separate* property is supposed to protect against. Reading a judge's property division decision often leads to the conclusion that the judge, seeking a *fair* outcome, simply ignored the marital/nonmarital property distinction.

Invasion Statutes: Two Michigan statutes authorize a divorce court to 'invade' a spouse's *separate* property based either on contributions made to its preservation or enhancement by the non-owning spouse, such as when marital assets are used to improve an inherited asset [MCL 552.401] or if the non-owning spouse continues to have financial need even after part of the marital estate has been awarded to him/her. [MCL 552.23.]

Commingling: Then other equitable principles also come into play when the judge is dividing assets as part of a divorce settlement, which can cause one's *separate* property received through gift or inheritance to be included in the divided 'marital' estate, e.g., when gifted or inherited assets are commingled with marital assets and the gift or inherited asset cannot be traced; or, when the other spouse's name is added to the title to the inherited asset to avoid probate. Other states simply classify all assets, whether gifted or inherited, as part of the marital estate; while these other states may be common law states, the trend is clearly for a divorce judge to operate under more *community* property-like principles- the 'partnership' theory of marriage. Even when the *separate* property nature of a gift or inheritance is respected by the court, if the court will look at the economic circumstances of the spouses and may nonetheless consider one's *separate* property when determining the equitable distribution of the 'marital' property, even if that *separate* property interest is in the form of a beneficial interest in a third-party

trust.

Examples: A couple of startling examples of this trend to treat inherited interests in trusts as vested property interests for property division purposes in a divorce are the following:

In *In re Marriage of Balanson, 25 P.3d 28 (Colorado, 2001)* the court considered whether a wife's remainder interest in a joint trust that her parents created, which became irrevocable on the death of one parent (her mother) was marital property, even though the father as the surviving settlor and life tenant could receive corpus distributions for his lifetime. The divorce court found that the wife's interest in the trust was a *vested remainder* interest even though she had to survive her father to take, with the court concluding: *"a present fixed right to future enjoyment gives rise to a vested interest in property, even if that interest is subject to complete divestment or defeasement."*

In *In re Marriage of Beadle, 968 P.2d 698 (Montana 1998)* the court noted that one beneficiary *"was sure to inherit so long as he did not predecease his mother, or she did not deplete the trust corpus. Therefore, we labeled his interest in the testamentary trust a vested remainder subject to divestment"* which then caused his 'vested' beneficial interest to be included in the marital estate for property division purposes.

The upshot is that the law of many states is very 'progressive' when it comes to what is included in a marital estate to be equitably divided between spouses, and the old distinction between *separate* property and marital property is blurred when a judge wields his/her authority to make an *equitable* division of available wealth.

Question: All of which then begs the question: how will a divorce judge treat a beneficiary's equitable interest in a third-party trust, including a contingent future interest that may never vest in possession? In many of the reported cases in recent years it is apparent that a divorce judge either does not understand

trust law or future interests, or the judge failed to apply generally accepted principles for the valuation of a beneficial interest. Which then leads to the follow-up question of whether a third-party trust like a dynasty-type Trust can be drafted to better protect a beneficiary's interest in that Trust from their spouse's property claims in a divorce.

Drafting Third Party Trusts in Contemplation of a Beneficiary's Divorce: Topics for a settlor to consider when drafting a third-party Trust for beneficiaries who may face a divorce in the future include the following:

Choice of Law: While a Trust instrument might have a provision that announces that it is governed by the laws of Michigan, probably the law of the trust beneficiary's domicile, and not any law specified in the Trust instrument, will apply, or the law that otherwise applies to the Trust's administration will control. Conflict of laws principles usually control how the beneficiary's domicile treats the beneficiary's interest in the trust, e.g., vested, contingent, or a mere expectancy? Depending on the state where the beneficiary lives could have a substantial impact on how the beneficiary's interest in the trust will be viewed by the divorce court, the Trust instrument should authorize the situs of the Trust, and its governing law, to be changed if warranted. That said, a strong choice of law preference provision in the Trust instrument might also give the trust beneficiary some room to negotiate when the issue of the nature of his/her interest in the trust is subject to debate.

Trust Directors: Due to the vagaries of choice of law and the mobility of trust beneficiaries from state-to-state, the Trust instrument should be made sufficiently flexible to adapt to changes in circumstances. For example, a trust director may be given a power of appointment to alter or divest a beneficiary's interest in the Trust. This ability to 'disinherit' the beneficiary may be sufficient to preclude a divorce judge from counting an interest in the Trust or treat it as the *property* of the 'taker-in-default' individual. Or a trust director might be given the power to extend that interest held in trust rather than to distribute the interest outright when a specific event occurs, e.g., attaining age 40, or to extend the interest in

the trust to foreclose the beneficiary's right of withdrawal. By the same token, thought needs to be given to the authority given to the trust director, which is the equivalent to a power of appointment, since the presence of that broad power, given its scope, could be viewed as a vested property interest in the trust director's own divorce proceeding.

Contemplate the Beneficiary's Divorce: The Trust instrument could be drafted to specifically address a beneficiary going through a future divorce, beyond just giving a trust director the ability to alter the terms or the beneficiaries of the Trust. The Trust instrument might expressly direct the trustee to take an active role in the divorce, funded by the Trust, expressly designed to oppose any effort by the beneficiary's spouse to acquire trust property. The trustee could also be given discretion to finance the beneficiary's legal costs in a property settlement that imperils the Trust.

Beneficiary's Use of Trust Assets: The Trust instrument could have distribution provisions that authorize the trustee to invest in personal use assets like an auto or residence, which the trust beneficiary may use or occupy, but never actually own, and thus those trust owned assets may not be marital property that is subject to the equitable distribution. This authority given to the trustee might extend to making improvement to assets that are already owned by the trust beneficiary.

Use of Entity "Wrappers:" The trustee could be granted the express authority to insulate property held in the Trust using a family limited partnership or an LLC that denies or restricts rights of any transferee from family member owners. Whether the presence of the restricted entity 'wrapper' will be more effective than a spendthrift limitation is open to debate. Then again, if a divorce judge considers distributing the entity interest from the Trust to the beneficiary's spouse as part of the divorce settlement, that spouse will be very reluctant to take the 'wrapper' interest since it is illiquid, unmarketable, and only subject to a charging order remedy.

'Death Knell' Provision?: The presence of a spendthrift provision in the Trust instrument may not provide much protection as desired by the Trust's settlor, or the trust beneficiary, particularly if spousal support or child support claims are asserted against the Trust. [MCL 700.7504(1)(a).] A more draconian provision, called a *cesser* clause under English law, might then be considered. This clause causes a forfeiture of an interest if it is attached or, triggered if the beneficial interest in the Trust counted in the equitable distribution of the beneficiary's assets in any way. The presence of a *cesser* clause may prompt the beneficiary's spouse (or the divorce judge) to think twice before pursuing claims against the Trust- then again, it's presence could be used to extort the trust beneficiary to make concessions if threatened by the beneficiary's spouse.

Use a *Spray* Distribution Trust: A divorce judge might shy away from including an interest in a Trust in the marital estate if that interest is hard to value. If there is a group or class of trust beneficiaries, and no one beneficiary has an exclusive right to receive anything at any time, it will be difficult for the judge to place a value on one beneficiary's discretionary interest in the Trust. Candidly, however, even if there are several potential beneficiaries, but in practice the trustee only makes a distribution to only one of the trust beneficiaries so that a pattern of distributions can be discerned, then the judge may still take the Trust into consideration, concluding that the trustee will be obliged to continue to make distributions to that one beneficiary. [For an example of this judicial willingness to ignore other trust beneficiaries' interests, see *Pfannenstiehl v Pfannenstiehl, 37 N.E. 3d 15 (Massachusetts Court of Appeals, 2015*.]

Use a *Discretionary Trust*: We have covered this option at length in prior missives over the years. Michigan's Trust Code contains very favorable provisions when it comes to protecting a Trust from creditor claims, including the claims of a beneficiary's spouse or former spouse, if the Trust instrument meets the definition of a *discretionary trust*. The transferee or creditor of the trust beneficiary of a *discretionary trust*

provision does not have a right to any amount of trust income or principal that may be distributed only in the exercise of the trustee's discretion, and trust property is not subject to the enforcement of a judgment until income or principal, or both, is distributed directly to the trust beneficiary, i.e., only when the property is in the hands and under the control of the trust beneficiary. [MCL 700.7505.] Moreover, for divorce property division purposes, if a spouse is the beneficiary of a *discretionary trust* [defined at MCL 700.7103(d)] then the beneficiary is determined, by statute, to not have a *property interest or right* in the Trust. [MCL 700.7815(1).]

"A beneficiary of a discretionary trust provision as described in section 7505 has no property right in a trust interest that is subject to a discretionary trust provision and has no right to any amount of trust income or principal that may be distributed only in the exercise of the trustee's discretion."

This was the result in the recent Michigan Court of Appeals case *In re Antonia Gualtieri Living Trust, No 342826 (March 19, 2019).* In that case the trustee was directed to "*shall* apply to, or for the benefit of the beneficiary, as much of the net income and principal from the Trust as the trustee deemed advisable for the beneficiary's education, health, maintenance, and support." Because the word *shall* preceded the words *sole and absolute discretion,* the court concluded that a *discretionary trust* was intended, and that the ex-wife of the beneficiary was unable to compel the trustee to make a distribution from the Trust that could be attached by her in satisfaction of the beneficiary's child support and alimony arrearages.

Conclusion: How a beneficiary's interest in an irrevocable Trust is fast moving these days, with a clear trend of courts to, in some manner, include the Trust or the beneficiary's interest in the Trust, in an equitable division of the 'marital' estate. Old notions of *separate* property received by gift or inheritance are disappearing. As Professor Jeff Pennell recently observed: "*It is more difficult to insulate wealth in divorce than it is at death, because property division rules virtually everywhere operate very much like the community property*

rules." How a long-term irrevocable Trust is drafted, with a trust beneficiary's divorce contemplated as a possibility, should lead to including in the Trust instrument provisions to help preserve what is left of the beneficiary's inheritance.