

Powers of Withdrawal: The Good and the Ugly

A beneficiary's withdrawal rights over an irrevocable trust can add significant flexibility to the trust, avoid transfer taxes, and save or shift income taxes. However, broadly described withdrawal rights can also expose trust assets to unwanted creditor claims.

Background: Over the past few years these missives have covered powers of withdrawal in several different planning contexts. For example, the missives have covered a conventional *Crummey* withdrawal right to 'convert' gifts to an irrevocable trust to *present interest* annual exclusion gifts for the trust beneficiary. [IRC 2503(c).] Or, they have covered the use of a withdrawal right held by a trust beneficiary to expose the trust's income to the beneficiary's much lower marginal federal income tax bracket, the trust as a BDIT (a beneficiary defective income trust.) [IRC 678.] Or many missives have covered the use of a beneficiary's withdrawal right as a means to expose the trust-owned assets to an income tax basis adjustment, or 'step-up,' on the beneficiary's death. [IRC 2041 and IRC 1014.] And, on a couple of occasions, missives have addressed the flexibility of a beneficiary's 5% + \$5,000 withdrawal right over a trust's principal which renders the power gift-tax neutral when the withdrawal power lapses. [IRC 2514(e).] All of these benefits can be derived by the use of a carefully drafted withdrawal power that is held by a trust beneficiary.

Power of Withdrawal Factors: The level of flexibility added to an irrevocable trust that can be attained with a trust beneficiary's withdrawal power is usually tied to four different factors that clearly describe and/or restrict the trust beneficiary's power of withdrawal

What is the Withdrawal Power Over? The power of withdrawal is usually limited either to a dollar amount or to a specific percentage of the trust's income or corpus, or perhaps even in some cases over the entire trust corpus. Keep in mind, too, that these express limitations can change over time while the trust exists, or they can be altered with changing events associated either with the trust beneficiary or the size of the trust's corpus or income. The most common example is a 5+5 withdrawal power that is limited to either \$5,000 a year or 5% of the trust corpus, whichever amount is larger. Yet, if the trust beneficiary encounters creditor problems, or is involved in a divorce, that beneficiary's power of withdrawal can be automatically suspended by the terms of the trust.

What is the ‘Trigger’ Event on Which the Power Can be Exercised? The trust beneficiary’s right of withdrawal can be activated with a contribution to the trust, e.g., a *Crummey* withdrawal right, by the passage of time, or a life event, e.g. a divorce, or solely based on the beneficiary’s decision. A common example is to give a surviving spouse a contingent 5+5 power of withdrawal over a credit shelter trust’s principal, which condition is satisfied once the marital trust that was created for that same surviving spouse becomes exhausted as result of withdrawals and/or distributions. Alternatively, the surviving spouse can be granted an immediate 5+5 power over a credit shelter trust, but that power would automatically lapse on the surviving spouse’s remarriage.

What is the Period During Which the Power Can be Exercised? A power of withdrawal held by a trust beneficiary is usually limited by an exercise period, during which the power can be exercised, e.g., the 30-day period that is often associated with a *Crummey* withdrawal right that starts once the trust beneficiary is provided written notice of the contribution to the trust delivered by the trustee.

What Happens if the Power Lapses? If the power of withdrawal held by the trust beneficiary lapses, i.e., the ‘window’ period during which to exercise the power is available to be exercised, a power of withdrawal provision normally describes what happens to the assets when the unexercised power ceases to exist. Along the same lines, a disclaimer can result in the disclaimed assets to a sub-trust that is subject to a beneficiary’s withdrawal right, but only if the trust instrument clearly describes what happens to disclaimed interests.

Creditor Rights: Lurking behind all this flexibility that a power of withdrawal can add to a trust instrument is the problem of creditor claims against the trust beneficiary. Usually if the irrevocable trust is a self-settled irrevocable trust, a retained power of withdrawal held by the settlor over the trust will not protect the trust’s assets from judgment creditors, unless the trust is one of the few statute-authorized domestic asset protection trusts (DAPTs) but even with those statutes where the settlor retains an interest in the trust, the settlor’s interest is a discretionary interest, and not an express power of withdrawal.

If the irrevocable trust is created by a third-party, then it is less clear what rights a judgment creditor will have to access trust assets. Most state common laws treat a presently

exercisable withdrawal right held by a third-party trust beneficiary as accessible by the trust beneficiary's judgment creditor. The underlying theory is that if that power of withdrawal is enforceable by the beneficiary, it is an attachable asset. Accordingly, by way of example, even if a *Crummey* withdrawal right can only be accessed in a 30-day window, the beneficiary's judgment creditor can still access trust assets during that 30-day period. Because of this exposure of trust assets to creditor claims, for example, an 'annual' 5+5 withdrawal power over a credit shelter trust held by a surviving spouse is often narrowed to a short period of 15 to 30 days, e.g., "this power of withdrawal conferred on my surviving spouse over this trust may only be exercised by her during December 1 through December 15 of each year, and her failure to exercise this withdrawal right during that 15-day period shall cause that right to lapse for that calendar year."

Bankruptcy: Even more challenging is when the trust beneficiary files for bankruptcy while holding an unexercised power of withdrawal over trust assets. Does the unexercised power of withdrawal become property of the bankruptcy estate? The bankrupt's estate includes all legal and equitable interests of the debtor as of the petition date. [11 U.S.C. Section 541(a)(1).] While the Bankruptcy Code excludes a debtor's interest in a spendthrift trust to the extent that the restriction is enforceable under state 'nonbankrupt' law, some courts have treated an unexercised, aka 'open,' withdrawal right differently from a protected beneficiary interest in a spendthrift trust. A couple of examples follow:

Example 1: In *Meoli v Thrun (In re Frisch) Adversary Proceeding No. 13-80072, Case No. DG 11-12290, Bankruptcy Court, Western District of Michigan, June 26, 2013*, the Court held that the debtor's withdrawal power effectively gave him the equivalent of complete ownership over the trust property that was subject to that power, which rendered the trust's spendthrift restriction ineffective as to those assets. Accordingly, once a bankruptcy petition is filed, the bankruptcy trustee steps into the debtor's shoes and can exercise any unelapsed withdrawal right that the debtor-beneficiary could have exercised on the date of the bankruptcy petition, thus dragging 'withdrawable' trust assets into the bankrupt's estate.

Example 2: In *re Hoff*, 644 F.3d 244 (Fifth Circuit, 2011). In this case, Mary created a spendthrift trust for the sole benefit of her grandson, Terry. That trust created an exception to its spendthrift restrictions: after Mary's death, Terry could withdraw specified portions of trust principal, one-third at age 30, one-half at age 35, and the remaining trust principal at

age 40. Terry filed for Chapter 7 bankruptcy at age 37 without having exercised any withdrawal rights over the trust. The Court held that Mary was the trust's sole settlor, and because she was still alive when Terry turned age 30, the age-30 withdrawal right never accrued, but because Mary had died after Terry's 30th birthday and before his 35th birthday, the age-35 withdrawal right did accrue. Even though Terry had not exercised that withdrawal right before he filed for bankruptcy, he remained entitled to withdraw one-half of the trust principal calculated as of his 35th birthday. Consequently, the bankruptcy trustee could exercise Terry's vested withdrawal right for the benefit of Terry's bankruptcy estate and his creditors.

State Statute Protection: In light of this exposure to bankruptcy claims, a few states have adopted specific statutes to provide that an unexercised withdrawal power over a third-party trust does not expose trust assets to the powerholder's creditors unless, and until, the power is actually exercised. One of the four states that have adopted this special rule is Delaware's statute, which protects an unexercised power of withdrawal from a judgment creditor's reach and confirms that a lapse of that power of withdrawal does not constitute an *exercise* of that power by the powerholder. [Delaware Code, Title 12, Section 3536(a)(4) and (c)(1).]

Power of Withdrawal Considerations: When considering, or reviewing, a beneficiary's power of withdrawal to be added to a trust some random thoughts include the following:

- (i) be sure to define the exercise 'window' clearly. An open-ended or renewable right will sustain an IRC 2041 general power of appointment and/or continuing IRC 678 treatment as a BDIT. An annual withdrawal widow with clear lapse provisions is preferable when inclusion is not the goal.
- (ii) confirm in the trust instrument that a lapse or release of the power of withdrawal does not cause the powerholder to become an additional settlor of the trust.
- (iii) if dealing with a 5+5 power of withdrawal, where gift tax neutrality on a lapse of the power is the goal, consider the use of 'hanging powers of withdrawal' for larger amounts.
- (iv) a broad spendthrift limitation in the trust could be in conflict with a beneficiary's withdrawal right, so the settlor's intent needs to clearly address

any possible interpretation that impedes or confuses these disparate provisions.

- (v) select the situs of the trust carefully if the beneficiary is to hold a standing right of withdrawal. If the trust is to be administered in a common law state without a special statute (see above- the other states with such statutes are North Carolina, Georgia, and South Dakota) use very short window periods for the withdrawal and 'size' the 5+5 power carefully, e.g., 5% of a \$2.0 million trust corpus is \$100,000 that a creditor could snatch.
- (vi) if the intent is to have the trust taxed as a BDIT, clarify that is the settlor's express intent regarding who pays the income tax on the trust's income, and coordinate the trust's income tax provisions accordingly to that express intent; and
- (vii) if disclaimers of interests are contemplated, clearly specify where the disclaimed interests and powers go, and whether such 'landing' destinations for the disclaimed assets are to sub-trusts with beneficiary withdrawal rights.

Conclusion: rights can add significant flexibility to an irrevocable trust along with the ability to avoid transfer taxes or to shift income tax burdens. Balanced against that flexibility is the prospect of exposing trust assets to satisfy the powerholder's creditors. To mitigate the exposure to creditor claims will require careful drafting of the power of withdrawal provisions, using narrow window periods, or automatic conditions that either trigger, or suspend, withdrawal rights. The longer the expected duration of the trust, the more significant the beneficiary's withdrawal rights become. The bottom line? Withdrawal rights are not boilerplate provisions in a trust, and they need to be thoughtfully drafted.

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