

Irrevocable Trusts and Divorce

Take-Away: Direct or indirect control over assets transferred to an irrevocable trust can lead to estate tax problems for the transferor. That same level of direct or indirect control over trust assets might also lead to an unfortunate division of assets in a later divorce.

Background: The creation and funding of *dynasty*-type irrevocable trusts has become a popular estate planning tool over the past couple of decades. Assets transferred to an irrevocable trust that is intended to exist for multiple generations can avoid federal estate and generation skipping transfer taxes for decades while at the same time providing creditor protection for the trust's assets. The relatively recent phenomena of states repealing or extending their Rule Against Perpetuities laws can explain, in part, this growth of interest in establishing dynasty-type trusts. One principal danger with dynasty trusts however is that the trust's settlor might retain too much control over the assets transferred to the trust, which could lead to the value of the trust's assets being included in the settlor's gross estate for federal estate tax purposes. [IRC 2036(a) and (b).] Too much control, direct or indirect, can lead to unexpected estate inclusion and transfer taxes due to the settlor's retained interest in the lifetime transferred assets. Several missives over the years have focused on the estate tax risk presented by IRC 2036 when the fair market value of the transferred assets is included in the decedent's estate due to the settlor's indirect control of the trust's income, or his/her continued use of the trust's assets without paying fair rental value for their use. A recent New York Supreme Court trial court decision adds yet another concern when the settlor retains too much control over the *dynasty*-type trust: equitable distribution in divorce.

***C.S. v. R.H.*, 87 Misc. 3d 1201(A), 239 N.Y.S. 3d 917, 2025 NY Slip Opinion 51426(U) (2025)**

Facts: Husband and Wife owned significant wealth. (Their names were sealed so only initials were used to identify the spouses. For convenience, I will call them Herb and Wilma.) Between them, Herb and Wilma transferred over \$100 million to several irrevocable trusts and LLCs, for estate planning purposes. These entities were for the benefit of their children. Neither Herb nor Wilma was a beneficiary of any of these trusts. Wilma was named as the trustee or the Managing Director of the LLCs. Fairly typical of many

marriages, Herb controlled most of the assets and he made most of the decisions regarding their wealth, with Wilma going along and signing whatever *their* lawyer prepared for her to sign. The trusts were meant to protect their marital assets while permitting them to enjoy their use. Consequently, Herb managed the assets while Wilma served in the role as trustee. However, Herb retained in the trust and LLC documents the exclusive power to remove and replace Wilma as trustee and remove and replace her as the Managing Director of the LLCs. In practice, these irrevocable trusts funded their family expenses and supported their lifestyle, such as living in various residences owned by the trusts without paying rent or paying well-below market rents. As the court later noted after considering the evidence at trial, while Herb and Wilma were not trust beneficiaries, they lived as though there were beneficiaries of the trusts they had created.

Divorce: Wilma filed for divorce. That step then prompted Herb to exercise his retained powers. Herb removed Wilma as trustee of the trusts and as the Managing Director of the LLCs. Herb appointed a close friend to replace Wilma in these fiduciary roles. Adding to these ‘bad facts,’ Herb became involved with lease renewals which led to Wilma being evicted from her home. Herb also decanted the trusts; in the decanting process Herb consented on behalf of his minor children (the trust beneficiaries), to give himself more power over the trusts. The trust decanting also removed the right of his daughter-beneficiaries to receive trust assets when they attained the age 30. Even after the divorce was filed, Herb continued to use trust assets for his personal maintenance expenses. To put it mildly, Herb dug himself into a deep hole retaliating against Wilma for filing for divorce.

Dispute: The primary issue before the New York divorce court was whether the value of the assets held in the irrevocable trusts and the LLCs could be considered by the court when making an equitable division of the *marital* estate.

Divorce Court: The divorce judge found that the value of the trusts (and LLCs) could be considered when making an equitable division of the marital estate, notwithstanding the fact that neither Herb nor Wilma was a trust beneficiary. The judge principally relied on the facts that: (i) the majority of the spouses’ assets were held in these trusts (and LLCs); (ii) the spouses used those assets to fund and sustain their lifestyles during the marriage; (iii) Wilma reasonably expected to enjoy the use and benefits of the trust assets in the future; and (iv) Herb never relinquished control over the trusts’ assets.

Fraud on the Marriage: The judge acknowledged that the use of irrevocable trusts to avoid estate taxes and protect assets from creditors was a legitimate estate planning practice. In those situations, a divorce court will not divide trust assets in a divorce “when the parties were well-informed as to the trust terms or they had relinquished control over the assets and were not serving as trustees. However, assets held in *sham trusts* and the assets transferred to trusts in fraud of marital rights have not been afforded such protection and should be subject to actual division in the divorce proceeding.

“(1) marital property is sacrosanct , regardless of its form, title or how maintained and the court will protect the parties’ respective equitable interests therein, and (2) in furtherance of its mandate, the court must consider the parties’ conduct vis-à-vis marital property held in trusts in determining whether it should be included in the marital estate.”

Independent Legal Counsel: On numerous occasions throughout the judge’s 29-page decision she noted the effect that Wilma never had her own legal counsel to advise and guide her on the impact of the changes to the trusts or LLCs, or that she was often presented with the documents for the first time, each time, in the office of a lawyer who Wilma assumed was representing her interests as her lawyer. The judge found that Wilma did not know the details of any of the financial assets and transactions, real property purchases, or tax matters, from which the judge concluded that Wilma trusted Herb and relied on his assurances that the trusts were meant to protect their enormous wealth, while permitting them to enjoy their use and to benefit from them. Apparently, Wilma never had any real opportunity to review and understand what she was doing when she was presented with documents that she had to sign-she trusted Herb and *their* attorney.

Equitable Division: The divorce judge considered the trust assets as part of the equitable division of the marital estate, even though title to those assets was in trusts or separate LLCs and not Herb or Wilma’s names. The judge found that Herb retained both direct and indirect control over the trust assets, and that he caused the trust assets to be used to pay family maintenance expenses. Therefore, the judge awarded Wilma 50% of the \$181 million marital estate. The conduct of Herb and Wilma carried more weight with the divorce judge than the fact that neither had a legally enforceable beneficial interest in the trusts they had funded. Wilma’s share of the ‘marital estate’ was with assets not held in the trusts; Herb was awarded the assets held in the several trusts or LLCs.

Estate Planning Considerations: A couple of thoughts come to mind after reading this New York divorce decision:

Estate Inclusion: Wilma and Herb used their applicable exemption amounts to fund the various trusts over the years. When Herb dies, one would suspect that the IRS will submit a copy of the divorce judge's decision to support its assertion that IRC 2036 applies to the various trust to mandate their asset values be included in Herb's gross estate for estate tax purposes. The divorce judge clearly found that Herb had retained dominion and control over the assets that he and Wilma had transferred to the trusts, and that same conclusion would apply as well to the application of IRC 2036. Estate inclusion arises when the facts demonstrate an implicitly retained interest in property; *"the crucial characteristic is that virtually nothing beyond formal title changed in the decedent's relationship to his assets."*

Applicable Exemption Amount: This divorce decision does not say if marital assets were used to fund the trusts, or whether Herb, or Wilma's, separate property was transferred to the trusts. Was Wilma fully advised as to the impact of using her applicable exemption amount to fund the trusts, where Herb seemed to have full control over those transferred assets?

Separate Property: In a divorce in many states, a spouse's separate property is supposed to be removed from the pool of assets that is subject to the divorce court's equitable division. It would be a harsh result if Wilma had used her separate property to fund these irrevocable trusts in which she had no beneficial interest, while Herb retained his separate property outside the trusts, which arguably would then be excluded from the divorce court's consideration and distribution. Did *their* lawyer advise either of them as to the risk of funding the irrevocable trusts with separate property?

Joint Legal Representation: Wilma thought that *their* attorney was looking out for her best interests when she was told to sign various documents to fund the trusts and LLCs. With hindsight, that apparently was not the case. Was *their* lawyer's engagement letter for that joint representation carefully drafted to address ethical considerations and potential conflicts that might arise in the future when multiple trusts or LLCs were funded using marital, or separate property, assets, e.g., the provision that gave Herb the unilateral right

to remove and replace Wilma as trustee or Managing Director of the LLCs? One wonders how *their* attorney responded when he was asked by Herb to prepare documents to remove Wilma as trustee and as Managing Director of the LLCs, or to formally prepare a new trust to decant trust assets, which eliminated Wilma's daughters' distribution rights.

Conclusion: This New York decision is a cautionary tale regarding indirect dominion and control over trust assets and the perils of a joint engagement by an attorney in estate planning for spouses. While dynasty-type trusts are popular estate planning tools these days, and for good reasons, they should be approached carefully, both with a joint engagement by spouses, with an eye towards whose assets are to be used to fund the trust, and the need to monitor the trusts to ensure that the settlors have not retained both direct and indirect control over trust assets and income. There is probably very little that can be done to prevent someone like 'Herb' from acting out with stupid emotion when confronted with a divorce.