

# **Mandatory v. Discretionary Trusts:**

## **Asset Protection Opportunities You and Your Client Must Know**

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# Introduction

## ■ Today's Objectives:

- Analyze differences in Mandatory vs. Discretionary Trusts
- Discuss recent IRS developments regarding levy and attachment of trust distributions
- Consider some potential negative consequences of Mandatory distributions
- Explore Asset Protection advantages of Discretionary distributions
- Highlight benefits for you, the trusted advisor



# Definitions

- What is a Mandatory Trust?
- What is a Support Trust?
- What is a Discretionary Trust?
- What is a Spendthrift Trust?



# Definitions

## ■ **Mandatory Trust:**

- A mandatory trust requires the trustee to distribute all trust income to a beneficiary. The trustee must distribute trust principal in a predetermined manner (outright, 25/35 etc.).
  
- See Example Language.



# Definitions:

## ■ **Support Trust:**

- Directs the Trustee to distribute only as much of the income or principal as necessary for the support and maintenance of the beneficiary.
- Watch Medicaid.
- See Example Language.



# Definitions:

## ■ Spendthrift Trust:

- When a trust is created, the grantor can specify in the trust that the BF cannot transfer, in any way, his interest in the trust, and that the BF's creditors will have no rights to trust assets so long as the assets remain in the trust. Once distributed, the assets are fair game to creditors.



# Definitions:

## ■ Spendthrift Trusts (Continued):

- **Example Clause:** Neither the principal nor the income of any trust hereunder shall be liable or subject to the contracts, debts, liabilities or torts, now or hereafter made, contracted, incurred or committed, of any beneficiary; nor shall the principal or income of such trust be liable to attachment by garnishment proceedings or other legal process; nor shall any assignment or order, either of principal or income, given by any beneficiary be valid but the principal and income shall be paid by the Trustee direct to or for the use of the beneficiary entitled thereto, without regard to any assignment, order, attachment or claim whatsoever. Every such attempted assignment or other disposition by any beneficiary shall be not merely voidable, but absolutely void. No payment hereunder shall become the property of any beneficiary until it is received by him or his guardian.



# Definitions:

## ■ Spendthrift Trusts (Continued):

- Except in a few states, spendthrift clauses are NOT effective against creditors of a BF who is also the Grantor -- what we call a *self-settled spendthrift trust*.
- These types of trusts are often called Domestic Asset Protection Trusts (DAPTs), and are recognized only in DE, AK, NV, RI, UT.
- It will be interesting to see the impact on DAPTs, if any, from the IRS Memo we turn to shortly...



# Definitions:

## ■ Spendthrift Trusts (Continued):

- Spendthrift Trusts are a protection under *state* law, developing through case law or statute. They are State-created exemptions.



# Definitions:

## ■ Discretionary Trust:

- A discretionary trust gives the trustee complete freedom to decide the amount of income and/or principal, if any, to distribute, to whom the trustee will distribute trust income and/or principal, and how it will be distributed.
- **Trustee can spend assets for BF's benefit to avoid creditors.** For example, trustee pays mortgage, medical bills, utility bills, education expenses, etc. directly to payee – rather than making a distribution to BF who wants to make the same payments on his own, but which his creditor will first attach.
- See Example Language.



# Definitions:

## ■ **Discretionary Trust (Continued):**

- However, keep in mind that Mandatory distributions are the only option in some cases
  - **Example:** Income to Spouse in a marital trust situation in order to preserve estate tax marital deduction.
- Trustee independence a Must (3<sup>rd</sup> Party)



# Recent IRS Developments:

- **ILM 200614006** (Nov. 30, 2005, released April 7, 2006)
  - **Summary:** In this internal memorandum, the Service has concluded that it may levy against a spendthrift trust where the taxpayer-beneficiary has fixed, determinable right to income (now) and principal (now or in future)
  - The IRS also concludes that it can sue (under state law) a Trustee for tortious conversion of the federal tax lien – A trustee who distributes funds that he or she knows is encumbered can be liable.



# Recent IRS Developments:

## ■ **ILM 200614006**

- **Facts:** Settlor executed a trust agreement. Trust provided that on his death, the trust shall be divided into equal shares for each of his children and grandchildren. Trust had spendthrift protections. Taxpayer was a child of settlor and was allocated one share of the trust estate. Taxpayer currently receives income dist. from the trust on a monthly basis. Trust provided Trustee shall distribute  $\frac{1}{2}$  of trust principal a fixed number of years after settlor dies, and balance of corpus another fixed number of years thereafter.
  
- Taxpayer has fixed tax liabilities due and owing to the IRS.



# Recent IRS Developments:

## ■ **ILM 200614006**

### □ **Applicable Law:**

- Federal tax lien “attaches” to all property and rights to property of a delinquent taxpayer.
- After attachment, IRS gives notice and demand for payment. If no payment, the IRS will “levy.”
- Levy seizes the taxpayer’s property and rights to property as of date of levy.
- Levy does not accelerate a right to future payment that is fixed and determinable.



# Recent IRS Developments:

## ■ **ILM 200614006**

### □ **IRS Analysis:**

- “If a Taxpayer has a fixed right under a trust to receive periodic payments or a lump sum distribution from a trust, the levy seizes the rights to such payments or distributions.”
- Levy effectively seizes the trust and distributions are made directly to IRS
- “Spendthrift provisions, which are state-created exemptions, cannot defeat a federal tax lien.”



# Recent IRS Developments:

- **ILM 200614006**

- **IRS Analysis: (Continued)**

- **Spendthrift Impact:** “The spendthrift provision of the trust, however effective against certain creditors’ claims, is ineffective at insulating assets of the trust from levy by the IRS – if the assets are first found to be the property or rights to property of the taxpayer.”



# Recent IRS Developments:

- **ILM 200614006**

- **IRS Analysis: (Continued)**

- **Income:** “The beneficiary-Taxpayer has right to all current income, paid monthly. Distribution is mandatory under the trust and not subject to the exercise of discretion on the part of the trustee. It follows then that such mandatory distribution is a property right of the taxpayer that may be levied by the service and collected when paid, now and into the future.”



# Recent IRS Developments:

- **ILM 200614006**

- **IRS Analysis: (Continued)**

- **Principal:** Like the income, principal distributions are mandatory and not subject to the discretion of the trustee. The right is fixed and determinable, so the levy seizes the taxpayer-beneficiary's present right to future payment. The levy does not accelerate the right of future payment, however.



# Recent IRS Developments:

- **ILM 200614006**

- **IRS Analysis: (Continued)**

- **Tortious Conversion:** The Service also concluded that if a Trustee knowingly distributes funds encumbered by the federal tax lien, and those funds are spent and nonrecoverable, the trustee is liable for tortious conversion
    - This presumes such a cause of action would be available under the applicable state law.



# Recent IRS Developments:

## ■ **ILM 200614006**

### □ **Lessons:**

- Spendthrift provisions, a state created exemption, are not effective against the IRS.
- If a trust provides for mandatory distributions without trustee discretion, the trust assets are at risk.
- If discretionary trusts can keep the Service at bay, all other creditors will be held off as well.
- Simply by building in trustee discretion, client's wealth is significantly more protected.
- This is a very simple, yet effective asset protection device that clients must be presented with during counseling.



# Discretionary Trusts:

## ■ Advantages for the Client:

- **Discretionary spendthrift trusts for the benefit of others provide substantial asset protection.**
- **Assets in discretionary spendthrift trusts are protected from the creditors of beneficiaries in bankruptcy, in divorce, and in post-judgment collection proceedings in even the most egregious personal injury, malpractice, and wrongful death cases.**



# Discretionary Trusts:

## ■ Advantages for the Client (Continued):

- Asset Protection
- Can build-in Divorce/Remarriage Protections
- Can build-in Addiction and Special Needs Protections
- Sliding Scale
- Hit Parade



# Discretionary Trusts:

- Our experience has been that during counseling, when options concerning distributions are fully explained to the client, probably 90% of them desire a lifetime protective discretionary trust for their loved ones as opposed to a mandatory trust.
- “Controlling from the grave” is not usually a big issue for the clients.
- The clients differentiate between protections from creditors vs. a sign that their loved ones are “bad with money.”



# Discretionary Trusts:

## ■ **Advantages for YOU, the Advisor:**

- These issues are something valuable to bring to your clients or new prospects, particularly if you are asked to review existing estate planning documents for them. How many canned forms have you seen that have mandatory distributions of principal?
  
- **Keep Assets Under Management**
  
- **Develop Relationships with the Next Generation Beneficiary**



The End.

*Thank you for Coming!*