

Oh Sh*t! There's a Trust!

Challenges, Contingencies and Complexities

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Trusts – 101

Ask early, ask often: Are you the beneficiary of a trust?

- If no, you can move on.
- If yes, first, “oh sh*t.” Then... deep breath. It’s going to be OK!

Trusts can be challenging, complex, contentious and confusing. First things first... ask for the **trust documents**. Then read them.

- The law surrounding trusts in Colorado divorces is evolving and often contentious because most of the law is based on case law, and often requires the assistance of family members.

Trusts – 101

- ▶ **What is a Trust?** A trust is a vehicle recognized under the law that holds property for the benefit of another.
 - Trusts are frequently used in estate planning as a means of transferring assets without transferring all of the incidents of ownership.
 - The purposes for establishing trusts are varied and include inheritance, tax avoidance, charity, creditor protection, and spendthrift concerns.

Trusts – Definitions

- ▶ **Grantor or Settlor.** The person or persons who establish the trust.
- ▶ **Trustee.** A fiduciary entrusted with care of the trust assets and the duty to carry out the settlor's intent as stated in the trust agreement. A trustee may be an individual or a corporate trustee.
- ▶ **Beneficiary.** The person or persons for whose benefit the trust is created.
 - **Current Beneficiary.** The person or persons who may currently receive trust distributions under the terms of the trust agreement.
 - **Lifetime Beneficiary.** A person who is authorized to receive distributions for the rest of his or her lifetime.
 - **Future Beneficiary.** A person who is not currently authorized to receive trust distributions, but who will be authorized to receive distributions at some time in the future. Example: *X is now age 25 and will be entitled to distributions only after the death of her mother and having reached age 40.*
 - **Contingent Beneficiary.** A person who will be authorized to receive distributions at some time in the future only if a future contingency is realized. Example: *X will be entitled to receive trust distributions if X has a net worth of \$1 million by the time X is 30. X is now 25.*
 - **Remote Beneficiary.** A person who could possibly be authorized to receive a distribution from a trust one day, but where the chances of a distribution are remote or far off. Example: *a trust benefits X and X's descendants, but if X dies without leaving descendants, then the descendants of Y will be authorized to receive distributions.* The descendants of Y are remote beneficiaries.
 - **Remainder Beneficiary.** A person who will be entitled to a distribution of trust principal upon the trust's termination.
- ▶ **Discretionary Interest.** A beneficiary has a discretionary interest when the trustee has discretion whether to make a distribution. Example: *"The trustee shall make distributions of income to X as the trustee determines for X's health, education, maintenance, and support."*
- ▶ **Non-Discretionary Interest.** A beneficiary has a non-discretionary interest in a trust when they have an enforceable right to receive trust income or principal. Example: *"X shall be entitled to 1/3 the trust principal at age 30."* Or *"X shall be entitled to distributions of all trust income, at least quarter-annually."*

Trusts – Definitions

- ▶ **Irrevocable Trust.** An irrevocable trust is no longer subject to modification by the Settlor.
- ▶ **Revocable Trust.** A trust that contains terms allowing the Settlor to amend or revoke the trust, or to withdraw the trust assets from the trust.
- ▶ **Principal.** (Sometimes called “**Corpus**”): The property that the trust owns that is under the management and care of the trustee.
- ▶ **Income.** Earnings from the principal of the trust, including stock dividends, interest, rents from real estate, earnings from business holdings, etc.
- ▶ **Powers of Appointment.** A power that is given to someone (the “power holder”) in a trust agreement to designate a future beneficiary of the trust after the termination of an existing right or interest.
 - **Testamentary.** The power of appointment is only exercisable at the death of the power holder; or
 - **Inter vivos.** The power of appointment is exercisable during the life of the power holder.
 - **General.** The power of appointment can be exercised in favor of anyone.
 - **Limited.** The power of appointment can be exercised in favor of only a limited class of people (*e.g., among X’s descendants*).
- ▶ **Powers of Withdrawal** (aka, “**Crummy Power**” or a “**5x5 Power**”). A power that is given to a beneficiary to withdraw some or all of the trust assets, usually at a specific time and for a specific limited amount of time. Often the power of withdrawal is included within the trust in order to qualify the trust for special tax treatment.
- ▶ **Self-Settled Trust.** A self-settled trust is a trust that is created by the Settlor for the benefit of the Settlor.

Trusts in Divorce – Relevance?

- **Property.** Does the trust create one or more beneficial interests that constitute “property” and that need to be allocated or accounted for in the division of property under C.R.S. §14-10-113?
 - If so, is the interest “separate property” or “marital property”?
- **Distributions/Income.** Has the trust made distributions to a spouse during the course of the marriage?
 - If so, are such distributions separate property or marital property?
 - Are the distributions income?
- **Economic circumstance.** Does the trust create an economic circumstance that should be considered when allocating marital property?

Types of Trusts

- ▶ 1) Revocable – can be terminated at any time the creator wishes
- ▶ 2) Irrevocable – cannot be revoked by the creator

Pro Tip: Whether your client thinks it is revocable or irrevocable, you need to review it, analyze it and verify.



Interests in Trusts

- ▶ Is there a Property Interest?
 - Separate? Marital?
- ▶ Is there an Income Interest?
 - How does that impact maintenance?
 - Modifiable? Non modifiable?
 - How does that impact child support?
- ▶ Is the trust an economic circumstance for the court to consider?

Trusts – Is it a Property Interest?

- ▶ General rule is that a revocable trust does not constitute a property interest to the beneficiaries.
 - (Exception is if the revocable trust is created by one of the spouses as a self settled trust.)
- ▶ Why not?
 - Can be revoked at any time.
 - No current enforceable right to beneficiary
 - The settlor owns the trust assets, not the beneficiary

Trusts – Is it Property?

Irrevocable trusts create enforceable legal rights to the beneficiaries.

BUT! Not every interest in an irrevocable trust constitutes property.

Irrevocable Trusts – Property?

(created by a third party)

- ▶ **Discretionary Interest -- Not Property.** A beneficiary's interest in an irrevocable discretionary trust created by a third-party is not property but a mere expectancy.
 - Where the trustee has the authority to determine if and when distributions are made, and the beneficiary has no enforceable contractual right in the trust, there is no property interest (and, therefore, no separate or marital property). *In re the Marriage of Balanson*, 25 P.3d 28, 41 (Colo. 2001); *In re the Marriage of Jones*, 812 P.2d 1152 (Colo. 1991) (discretionary interest in a trust is an “expectancy,” not a property interest); *In re Marriage of Pooley*, 996 P.2d 230, 232 (Colo. App. 1999) (same); *In re Marriage of Rosenblum*, 602 P.2d 892 (Colo. App. 1979) (same).
- ▶ **Remainder Interest – Property.** A remainder interest in an irrevocable trust is property. *In re Marriage of Balanson*, 25 P.3d 26, 41 (Colo. 2001). In *Balanson*, the W's mother had created a marital trust for the lifetime benefit of the W's father. The W's father had the ability to withdraw assets from the trust and he held a power of appointment at his death over the remaining trust assets. Nevertheless, unless he exercised the power of appointment (which he had not at the time of the divorce), the trust would terminate at W's father's death, and W would receive trust corpus at that time (thus, the remainder interest). The court explained that W had a “present fixed right to future enjoyment” that gave rise to a vested property interest, even though her interest was subject to complete divestment or defeasance if she were to predecease her father. *Id.*; see also *In re Marriage of Dale*, 87 P.3d 219 (Colo. App. 2003) (following *Balanson*); *In re Question Submitted by the US Court of Appeals for the 10th Circuit*, 553 P.2d 382 (Colo. 1976)(tax case holding that a vested remainder subject to complete defeasance is “property” to which a tax lien can attach).

Trusts – Remainder Interests

- ▶ The right to receive the corpus of the trust at some time in the future
 - Common language includes: “as necessary for the beneficiary’s health or education.”
- ▶ Vested Interest or Contingent Interest
 - Typically depends on whether the right to receive corpus is certain or uncertain
- ▶ Vested remainder interests are rights to future benefits (assets) and are subject to valuation and division in Colorado. In other words, they ARE property interests.

Distributions – Property?

- ▶ **Mandatory Distributions of Income – Not Property.** A mandatory right to income distributions is not “property” for purposes of a divorce where the beneficiary has only a discretionary right to trust corpus. *In re Marriage of Guinn*, 93 P.3d 568, 571 (Colo. App. 2004).
- ▶ **Mandatory Distribution of Principal – Property.** In *In re Marriage of Foottit*, 903 P.2d 1209 (Colo. App. 1995), the parties stipulated that W’s interest in a trust was separate property. The case does not explain why that stipulation was reached, but review of the briefs submitted to the court of appeals reveals that W was entitled to a distribution of trust corpus at age 35, which age had been reached during the marriage. While not so holding, this case supports the idea that a mandatory right to trust principal at any point (even if not a remainder interest) is a property interest.

Trusts – So it's a Property Interest

- ▶ **Remember: The Trust Terms Define the Interest.** Whether a beneficial interest in trust gives rise to a property interest depends on the terms of the trust.
- ▶ **If it is a Property Interest:** In addressing issues relating to the division of property pursuant to C.R.S. § 14-10-113, the court must engage in a two-step process: “First, a court must determine whether an interest constitutes ‘property’; if so, the court must then determine whether the property is marital or separate.” *In re Marriage of Balanson*, 25 P.3d 28, 35 (Colo. 2001).
- ▶ **More Than One Interest in Same Trust.** A party may have more than one beneficial interest in the same trust.
 - **For Example.** A trust may provide for X to receive mandatory distributions of trust income and distributions of principal within the trustee's sole discretion. In this example, X has two beneficial interests: an income interest and a beneficial interest in principal.
 - **Analyze Separately.** Each interest must be separately analyzed.

Trust Property – Self Settled Trusts

- ▶ **Self-Settled Trusts.** There are two Colorado cases addressing whether an interest in an irrevocable trust that is created by a spouse during the marriage gives rise to a property interest. At first blush the two cases conflict, but the reconciliation lies in the circumstances under which the trust was created. The two Colorado cases involving self-settled trusts are *In re Marriage of Kaladic*, 589 P.2d 502 (Colo. App. 1978), and *In re Marriage of Pooley*, 996 P.2d 230 (Colo. App. 1999).
 - Reconciliation of these two cases lies in the circumstances under which the trusts were created. In *Kaladic* the W had created the trust for the purpose of moving assets out of H's reach shortly before filing for divorce; a purpose that led to the transfer of assets to the trust being characterized as “illusory and colorable.” In *Pooley*, the transfer of marital property to the trust was for bona fide reasons unrelated to the divorce, and the W's interest in the trust was therefore analyzed under *Jones*.

Marital v. Separate Property

- ▶ **Separate Property.** Where a beneficial interest in an irrevocable trust gives rise to “property” that interest has been gifted to the beneficiary spouse and is, therefore, *always* a separate property interest. See *Balanson*, 25 P.3d at 42.
 - If the trust was created prior to the parties’ marriage, any beneficial interest held by a spouse would also be separate property pursuant to C.R.S. § 14-10-113, as the result of having been held prior to marriage.
- ▶ **Marital Property – Increase in Value of Separate Property.** However, if a beneficial interest is “property” and it has increased in value during the marriage, the appreciation on the (separate property) beneficial interest during the marriage is marital property pursuant to C.R.S. § 14-10-113(4). *Balanson*, 25 P.3d at 42.
- ▶ **Valuing the Increase in Value of Separate Property.** In valuing the appreciation of the beneficial trust interest during the marriage, one must determine both (1) the value of the interest on the date it was acquired by the beneficiary spouse or the date of marriage, whichever is later, and (2) the value of the beneficial interest on the date of divorce.
 - **Not Simple Math.** Valuation of the beneficial interest and its appreciation, if any, is not as simple as determining whether the trust assets themselves have increased in value. Determining the marital property component of a beneficial interest in trust based on the appreciation in the value of that interest typically requires expert witness opinion.

Marital v. Separate Property

- ▶ **Distinction Between Beneficial Interest and Distribution Itself.** If a beneficiary is eligible to receive distributions from a trust, then they have a beneficial interest in that trust that may be “property” depending on the terms of the trust, as described previously. When a distribution is actually received it is “property” – the question is whether it is separate or marital property.
- ▶ **No Property Interest in Trust Corpus – Separate Property.** Where a trust beneficiary has no property interest in the trust corpus, any distributions (whether of income or principal) are separate property akin to a gift.
 - Discretionary distributions of principal are separate property. *In re Marriage of Jones*, 812 P.2d 1152, 1158 (Colo. 1991).
 - Mandatory distributions of income are separate property where there is no property right in the trust principal. *In re Marriage of Guinn*, 93 P.3d 568, 571 (Colo. App. 2004).
- ▶ **Property Interest in Trust Corpus Makes Trust Income Marital Property.** Where the spouse has a beneficial interest in the trust corpus that gives rise to a separate property interest, the trust income (distributed or not) is marital property. *In re Marriage of Foottit*, 903 P.2d 1209 (Colo. App. 1995).

Income Interests in Trusts


The right to receive periodic distributions of income from the trust.

Income can be distributed, meaning it leaves the trust

Income can be undistributed; retained by trust and invested

Income interest can be mandatory which requires the trustee to distribute income, or

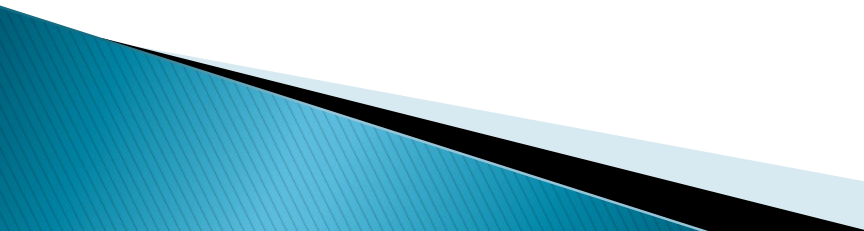
Income interest can be discretionary, which would allow the trustee to distribute income when deemed appropriate



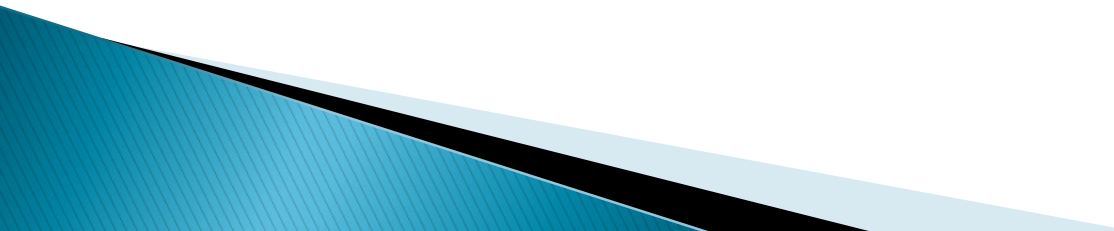
Trusts – Economic Circumstance

- ▶ **Consideration of Economic Circumstances.** C.R.S § 14–10–113(1) requires that the court “divide the marital property, without regard to marital misconduct, in such proportions as the court deems just” after consideration of a variety of factors, including the economic circumstances of each spouse at the time the property division is effective.
- ▶ **Economic Circumstance May Exist Even if There’s No Property Interest.** Even where a property interest is not found to exist as the result of a party’s beneficial interests in trust, the court may consider a trust, or the pattern of distributions received by a spouse from a trust, in dividing the marital property. *See e.g., In re Marriage of Pooley*, 996 P.2d 230 (Colo. App. 1999); *In re Marriage of Rosenblum*, 602 P.2d 892 (Colo. App. 1979).

Trusts – Confused?

- ▶ Consult a trust expert early on in your engagement to be sure there are no surprises.
 - ▶ Not every interest in a trust is property.
 - ▶ Case law and case specific factors create complexities that often require the opinion of a trust expert.
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Questions that Need Answers

- ▶ What kind of Trust is at issue?
 - ▶ Do I need an expert?
 - ▶ If so, which kind?
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Valuation Theory

- ▶ The value of an interest is dependent on the future benefits to the beneficiary and the risk of actually receiving those benefits.

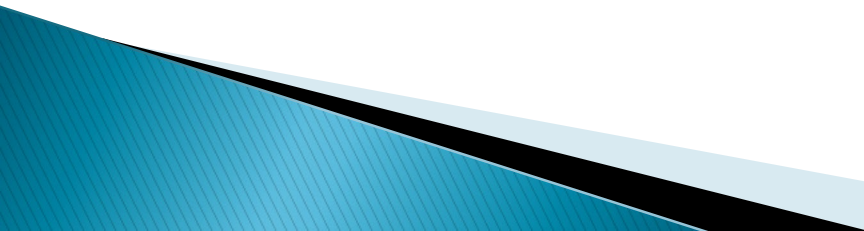
Valuation Methodology Case Law

Beach v. Beach

- ▶ "the fair market value of ... life estates ... is the present value of such interests, determined under paragraph (d) of this section."
- ▶ Paragraph (d)(2)(iii) of that section contains the valuation methodology for life estates and provides in relevant part:
 - If the interest to be valued is the right of a person to receive the income of certain property, or to use certain non-income-producing property . . . for the life of one individual, *the present value of the interest is computed by multiplying the value of the property by the appropriate ... life interest actuarial factor (that corresponds to the applicable section 7520 interest rate and ... life interest period).*

Valuation Methodology Case Law

Beach v. Beach – IRS Method

- ▶ Factors considered are:
 - Value of the assets at date of gift or date of marriage;
 - value of the assets at the date of dissolution; and
 - the life expectancy of relevant parties (or terms of the trust)
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Valuation Methodology Case Law

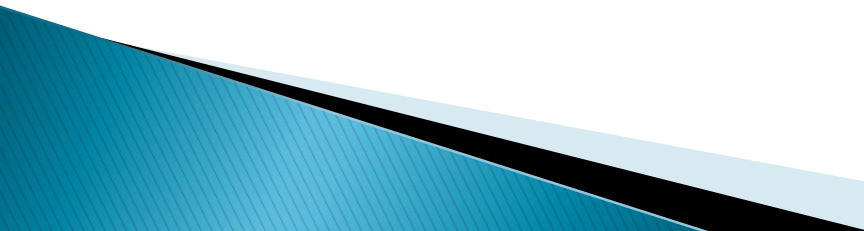
Marriage of Dale and Major

- ▶ Remainder interest appreciation is calculated based on the interest holders proportionate share in the overall growth of the trust during the marriage, discounted at 6% (we use the 20 year Treasury Bond rate) over the life interest holders remaining life expectancy at the date of the dissolution.

Valuation Methodology Case Law

Marriage of Dale and Major – Dale and Major Method

▶ Factors considered are:

- Value of the assets at the date of gift or date of marriage;
 - value of the assets at date of dissolution; and
 - the life expectancy of relevant parties (or terms of the trust)
- 

Valuation Methodology Case Law

Marriage of Balanson

- ▶ In the Colorado Supreme Court case *In re the Marriage of Balanson*, 25P.3d 28 (Colo. 2001), the Court stated "... appreciation is to be calculated by determining the extent to which the property's present value at the time of the decree exceeds its value at the time of acquisition. Footnote 6 states that "... the trial court may consider a variety of circumstances when determining the present value of the trust, including actuarial information concerning the life expectancy of the Wife's father and information concerning the probability and extent to which the father will need to invade principal for his maintenance."

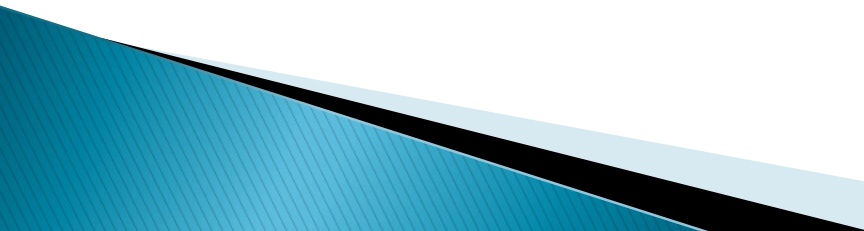
Valuation Methodology Case Law

Marriage of Mohrlang

- ▶ In the Colorado case *In re the Marriage of Mohrlang*, 85 P.3d 561 (Colo. App. 2003), the Court held that in determining the net present value of a vested interest that is subject to the contingency of survival to a future date, the court may consider, in addition to the *Balanson* factors, actuarial information concerning the life expectancy of the current beneficiaries as well as the risk of forfeiture due to the fact that the trust interests are inaccessible before a distribution date and terminable upon the remainder beneficiary's death. The Court also stated, "Admittedly, it is difficult to determine that present value of a vested interest in a trust that is subject to divestment based on a condition subsequent *In re Marriage of Gorman*, 36 P.3d 211 (Colo.App. 2001). However, valuation of such an interest should be accomplished by using an approach similar to that taken when valuing pensions."

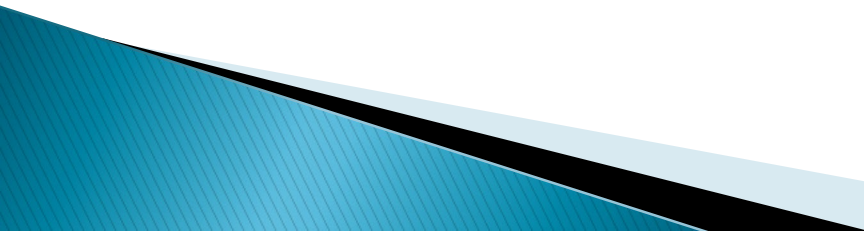
Valuation Methodology Case Law

Mohrlang Method

- ▶ The projection of future value is based on expected growth.
 - ▶ Provide for contingencies by either adjusting the discount rate and/or as an adjustment to the projected value.
 - ▶ Value after contingencies is discounted to present value.
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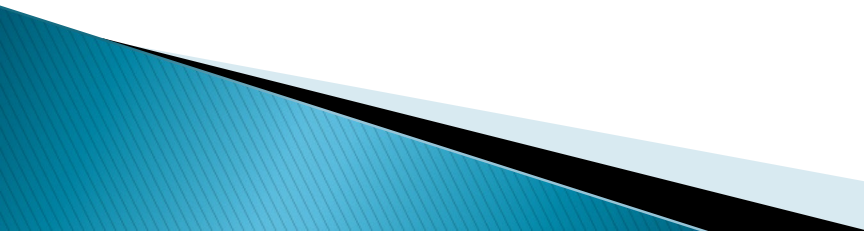
Valuation Methodology Case Law

Mohrlang Method

- ▶ The growth rate (future value) should be consistent with the underlying assets.
 - ▶ Discount rate (present value) should be adjusted for the risks created by the contingencies.
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Valuation Methodology Case Law


Mohrlang Method

- ▶ Factors to be considered are:
 - Value of assets at date of gift or date of marriage;
 - value of assets at date of dissolution;
 - life expectancy of relevant parties (or terms of trust);
 - risk of forfeiture;
 - invasion of trust assets; and
 - other contingencies.
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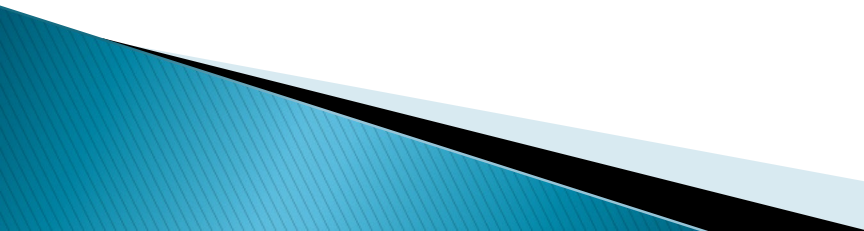
Applying the Three Pension Alternatives to Trust Interest

- ▶ *Hunt and Raimer* describes and discusses the three methods for division of a pension interest that are equally applicable in trust remainder interest cases.
- ▶ Depending on the magnitude of the value of the remainder interest and the rest of the assets in the marital estate, the immediate offset method may not be usable (except with an equalizing note).
- ▶ The other two methods of division cited in *Hunt and Raimer* are the deferred distribution method and the reserve jurisdiction method.
- ▶ Deferred division in a trust case would be equivalent to the use of a QDRO or DRO for a pension or a constructive trust in a stock options case, where a contract is drafted which creates rights for the non-trust beneficiary to receive funds in the future.
- ▶ We rarely, if ever, see the court reserving jurisdiction in these types of cases, however, if the interest is so difficult to place a value on because of conditions subsequent, this method may be the best method to achieve an equitable division.

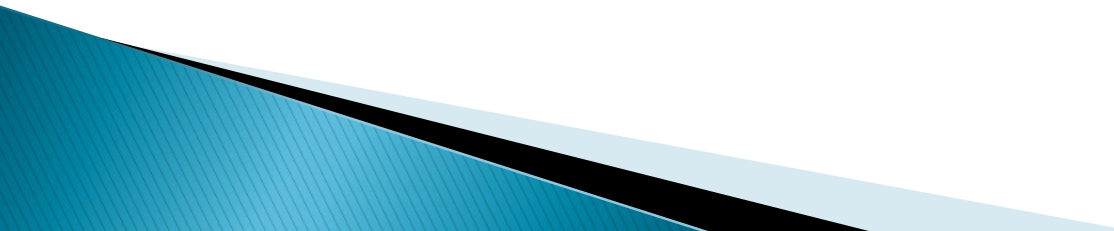
Trusts – Document Requests

- ▶ Trust instrument, including any amendments
 - ▶ The last 5 years' financial statements and the most recent interim financial statements, if such exist
 - ▶ Inventory of assets of the trust at tax cost and fair market value as of the current date
 - ▶ Inventory of assets of the trust at tax cost and fair market value as of the initial measurement date (initial measurement date is defined as the later of the date of marriage or the date of the trust became irrevocable)
 - ▶ List of distributions of trust principal to the beneficiary since the initial measurement date
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Trusts – Document Requests

- ▶ Date(s) of birth of the person(s) with the life estate
 - ▶ Any additional information which may be salient with regard to valuing the interest, such as health of the person(s) with the life estate, insufficiency of assets of person(s) with the life estate to support themselves, family issues that may affect the trust, etc.
 - ▶ Dates of birth of remaindermen, and a description of health or remaindermen
- 

Trusts – Document Requests

- ▶ List of contributions to the trust during the marriage which may constitute additional separate property, in part or in whole
 - ▶ Tax returns and financial statements of the trust from the initial measurement date through the current date
 - ▶ Any gift tax returns reflecting gifts to trusts or gifts of trust interests
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Trusts – Document Requests (a tip)

- ▶ Assets owned by trust may require different types of appraisals
 - Real Estate
 - Collectibles
 - Private Company Stock

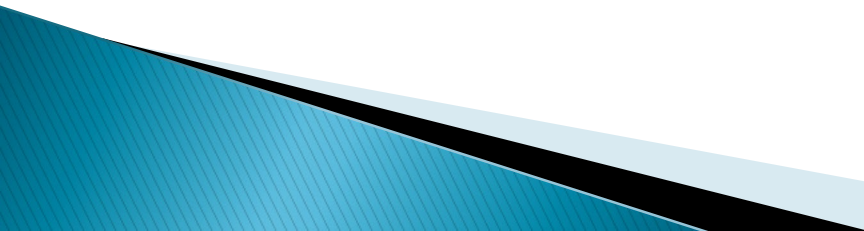
Trusts – Document Requests ILIT Trust

- ▶ Irrevocable Life Insurance Trust or ILIT
 - Designed to receive life insurance proceeds upon death, not taxable.
 - Generally, the proceeds are for the benefit of the spouse and then passes on to children or other beneficiaries.
- ▶ If the trust is an ILIT:
 - Copies of all life insurance policies;
 - details of all life insurance premium payments during the marriage; and
 - details of build up of cash surrender value during the marriage.

Challenges in Obtaining Data

- ▶ Trusts are created for the purpose of transferring family wealth to future generations.
 - ▶ Divorce of a beneficiary is typically not on the minds of advisors when creating the trust.
 - ▶ Inquiries regarding the trust is seen as intrusive.
 - ▶ May need to seek alternatives when the documents are not available.
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Dealing with Personal Issues

- ▶ This probably goes without saying, the term “trust fund baby” was not coined to elevate the status of the person to which it is applied.
 - ▶ The trust beneficiary almost always believes they are somehow entitled to money that they did not earn, and worse, that the person they are divorcing has no “entitlement” to the money.
 - ▶ Often, a couple’s lifestyle is entirely funded by trust receipts, and no money is saved because the trust fund money will always be there.
 - ▶ Accordingly, it is not unusual for the only assets in a case to be the equity in a residence, some personal property and the trust remainder interest, making division more difficult than in “normal” cases.
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Questions?

- ▶ Feel free to call us!