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What is a Spendthrift Trust?

We are often asked by parents or grandparents how they can leave money to their children or grandchildren, but still protect it from the child's or grandchild's creditors. Often, the concern is that the child or grandchild may squander the gift or inheritance if it is received outright. We often recommend a so-called "spendthrift trust."[1]

One of the advantages of being a trust beneficiary is that a trust created by a settlor for the benefit of a third person beneficiary (such as a child or grandchild) can protect the trust assets from claims of the beneficiary's creditors. One of the primary tools to achieve this result is the "spendthrift clause." Trusts which include such a clause are sometimes referred to as "spendthrift trusts." The spendthrift clause may also be advantageous in protecting a profligate beneficiary from himself or herself (hence the name of the clause).

Spendthrift trusts are valid and enforceable in Colorado. This was affirmed again recently by the Colorado Court of Appeals in 2013. *In re Estate of Beren, 321 P.3d 615 (2013).*

A typical spendthrift clause promulgated in a popular Colorado form book (The Orange Book Colorado Estate Planning Forms, published by CLE in Colorado, Inc.) reads as follows:

"No beneficiary shall have any right to anticipate, sell, assign, mortgage, pledge, or otherwise dispose of or encumber all or any part of any trust estate established for his or her benefit under this instrument. No part of such trust estate, including income, shall be liable for the debts or obligations of any beneficiary or be subject to attachment, garnishment, execution, creditor's bill, or other legal or equitable process."

Whether or not a trust contains a spendthrift clause, trust assets under the purely discretionary control of a trustee (who is not also the beneficiary or related to the beneficiary) cannot be garnished.[2] Thus, creditors of beneficiaries in Colorado cannot reach the assets of the trust to satisfy the beneficiary's obligations as long as the trustee has the sole and absolute discretion to distribute or not distribute trust income and principal to the beneficiary.

A purely discretionary distribution provision such as the following, would, under current Colorado law, not be subject to a creditor's claim against a beneficiary:

"During the Trust Beneficiary's life, the trustee may pay to, or apply for the benefit of the Trust Beneficiary, such amounts of the net income or principal, or both, as the trustee may determine, in the trustee's sole and absolute discretion."

In contrast to a purely discretionary trust, a creditor may garnish trust property that the beneficiary is entitled to, such as a mandatory income distribution from a marital trust or a Qualified Subchapter S Trust (QSST).

The disadvantages of discretionary spendthrift trusts include the fact that the beneficiary cannot force a distribution if the trustee has discretion to distribute or not distribute in the trustee's sole or absolute discretion. Further, once the assets have been transferred to the trust, they cannot be reclaimed, because to be effective, the trust must be irrevocable.

In addition to the creditor protection, significant tax advantages can be obtained for your children and grandchildren with the use of spendthrift and/or discretionary trusts. Spendthrift trusts can be created during your life or at your death. If you would like more information about these types of trusts, we would be happy to talk to you.

[1] This article only addresses Colorado law. Laws of other states may be different.
[2] This article only addresses trusts created by a third party for a named beneficiary or beneficiaries. The law regarding creditors' rights in self-settled spendthrift trusts in Colorado is unclear.

Should You, Must You, File a Gift Tax Return?

If you make a gift, you may be required to file a gift tax return reporting the gift. Some instances when a return is mandatory include the following:

1. You make a gift to any one person exceeding the gift tax annual exclusion amount, which is $14,000 in 2014. A gift can occur in a variety of ways, such as:
   - You write a check to another person.
   - You purchase property, such as a house or car, for another person.
   - You put another person on title to your property (i.e., you sign a deed transferring ownership to that person or retitling the property into both of your names).
   - You allow another person to use your property rent free.
2. If you are married, you and your spouse can each give $14,000 per recipient. However, if just one of you makes a gift of $28,000 to one person, then in order for the gift to qualify for the gift tax annual exclusion, a gift tax return must be filed and both spouses must elect to gift-split, which results in the gift being treated as made one-half by each spouse.
3. In order to qualify for the annual exclusion, the gift must be a "present interest."[1] Depending upon how the trust is structured, gifts to trusts may not qualify as present interests, in which case they do not qualify for the annual exclusion. Gifts that do not qualify for the annual exclusion must be reported on a gift tax return no matter the amount of the gift.
4. If a spouse creates a lifetime qualified terminable interest property (QTIP) trust for the benefit of the surviving spouse, a gift tax return must be filed and a QTIP election must be made in order to qualify for the gift tax marital deduction.

The gift and estate tax exclusion amount is currently $5,340,000. The gift tax annual exclusion is $14,000.

Even if a gift tax return is not required, it may be advisable to file a gift tax return, including for the following reasons:

1. Statute of limitation: If gifts are properly reported on a gift tax return in compliance with the IRS rules, then the IRS is limited to a three-year period to challenge matters relating to the gifts, such as the valuation of the gifts. Otherwise, the IRS could raise issues with the gifts years after the gift is made. Even if a gift tax return is filed, the statute of limitations does not run as to any matters not properly disclosed on the returns.

2. GST tax: Some gifts implicate the generation-skipping transfer (GST) tax. Whenever a gift is made to a trust, consideration should be given to whether GST exemption should be allocated to the trust. If GST exemption is not allocated, and if the trust eventually distributes to the grandchildren or more remote descendants of the person making the gift, GST tax may be imposed when the gift is made or in a future year when a distribution is made from the trust. The trust can be made exempt from GST tax by allocation of GST exemption. There are automatic allocation rules that may apply to allocate GST exemption. However, we recommend at least filing a gift tax return when the first transfer is made to the trust to affirmatively elect that the automatic allocation rules apply, or to elect that they not apply, as appropriate for the relevant trust.

The tax code is now over 3.8 million words long. Source: The Tax Foundation

There are several documents that must be, or should be, filed with the gift tax return, including the following:

1. Copy of the trust agreements, if any gifts were made to a trust;
2. Valuations of the gifts prepared by someone qualified to value the property; and
3. Crummey letters (discussed below).
   When contributions are made to an irrevocable trust, the trust may require that notice be given to all or some of the beneficiaries. These notices are referred to as "Crummey" letters, named after a court case. The purpose of the Crummey provision in the trust and the Crummey letters is to allow all or part of the contributions to qualify for the gift tax annual exclusion. It may be advisable to include copies of the Crummey letters with the gift tax returns to start the statute of limitations (discussed above) on matters relating to qualification of the annual exclusion. Recently, the IRS has sometimes been requesting copies of the Crummey letters if they are not submitted with the return. In anticipation of this issue, the trustee should be careful to send out Crummey letters in compliance with the terms of the trust, and keep copies of the letters.

Gift tax returns are due April 15th of the year following when the gift is made. A six month extension is available.

[1.] There are special rules that apply to gifts to a spouse or charity if the gifts qualify for the marital or charitable deduction. Those gifts may not require filing of a gift tax return, depending on the circumstances.

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ROLL CALL

Following up on his Keynote Speech at the Colorado Bar Association Trust and Estate Section Retreat in 2013, Tom Stover published an article in Estate Planning, a national estate planning journal published by Warren Gorham and Lamont, in March 2014, titled, "Will the Tax Tail Still Wag the Estate Planning Dog?" The article expands on the themes from the speech which were how the historic tax legislation passed at the end of 2012 will affect the estate planning practice and indeed how it will affect planning for all of our clients.

Tom attended the annual national meeting of the American College of Trust and Estate Counsel in Tucson, Arizona in March, and remains busy with his duties as Colorado State Chair of that organization.

Jennifer Spitz gave two presentations this year on tax topics for the Colorado Bar Association. The first was an introduction to the gift and estate tax marital deduction, and the second addressed several tax topics, including portability of the gift and estate tax exclusion amounts.

Stover & Spitz LLC is a Tier 1 Trust and Estates law firm, as recognized by U.S. News Best Law Firms.

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