

Litigating Discretionary Trusts in The Afterglow of ‘Tannen v. Tannen’

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Trusts are often established to protect a beneficiary from third-party creditors, or simply to create a future cash stream for the intended beneficiary. In the context of family law litigation, this form of protection, principally in the form of a “discretionary trust,” is often used to protect the beneficiary from the economic reach of his/her future ex-spouse. This article explores the impact of various forms of discretionary trusts in family law in the afterglow of the New Jersey Supreme Court case, Tannen v. Tannen.

The Tannen court addressed the issue of whether a court can compel distributions from a discretionary support trust and include those distributions as a source of income for the beneficiary-spouse in calculating alimony. While other states previously addressed the issue presented in Tannen, this case was one of first impression in New Jersey.

Discretionary Trusts

A discretionary trust grants the trustee the discretion to determine if, when and how much to distribute from the trust. Pursuant to the Restatement (Second) of Trusts, which is recognized in New Jersey, a discretionary trust exists “if by the terms of [the] trust ... the trustee shall pay to or apply for a beneficiary only so much of the income and principal or either as the trustee in his uncontrolled discretion shall see fit to pay or apply...” Restatement (Second) of Trusts 155(1); see also, 155(1) comment b. “[T]he beneficiary [of a discretionary trust] c[an] not compel payment to himself or application for his own benefit.” The limited nature of the beneficiary’s rights serves to limit the rights of any “transferee or creditor” of the beneficiary who similarly “[could] not compel the trustee to pay anything to him...”

In Tannen, the parties married in 1988. In 2000, the wife’s parents settled the Wendy Tannen Trust (WTT), an irrevocable trust with the wife as the sole beneficiary and the wife and her parents as co-trustees. There was no question that the WTT funded a substantial portion of the marital lifestyle, and generated at least \$124,000 per year in income for the family.

The creation and wording of the WTT was critical to the court’s analysis. In relevant part, paragraph 3(A) of the WTT provided the trustees “sole discretion to pay out the principal and income for the benefit of defendant’s health, support, maintenance, education and general welfare after taking into account the other financial resources available to defendant.” Tannen, at 264. Paragraph 3(C) provides that “it was the express intention of the grantors that defendant shall not be permitted under any circumstances to compel distributions of income and/or principal prior to the time of final distribution.” Paragraph 14, the spendthrift clause, of the WTT states that “defendant had no ability to alienate,

anticipate, pledge, assign, sell, transfer or encumber distributions from the trust.”

The Appellate Division in Tannen noted that N.J.S.A.2A-34-23(b) sets forth a list of factors that the trial court should consider in making any alimony award, including “income available to either party through investment of any assets held by that party.” The Appellate Division narrowed its inquiry as to whether the wife’s beneficial interest in the WTT was properly considered in the alimony calculation. It held that the trust income could not be imputed to the wife in calculating alimony. Accordingly, the wife’s “beneficial interest in the [WTT] was not an asset held by her.” The income that the wife received from the trust could not be looked upon as income to the wife for support, which would have reduced her financial needs.

The Tannen decision affirmed that in New Jersey, “a purely discretionary trust will be honored as giving the trustee unfettered discretion to distribute or not distribute, regardless of the support needs of the beneficiary.” E.g., Martin M. Shenkman, “Recent NJ Case Upholds Protection of Trust,” 30 *The Matrimonial Strategist* 2 (February 2012).

The court did not fully explore that the trust was partially self-settled by the wife, as the wife gifted the home to the WTT. Arguably, this fact should have opened the door to impute some level of income from the trust to the wife.

The Tannen court points out the importance of the exact language in discretionary trusts. The language used in discretionary trusts varies. The obligations of the trustee and the rights of the beneficiary are affected by such language variations.

Discretionary Trusts and the Reciprocal Trust Doctrine

In certain cases, parents may establish a discretionary trust for each of their children, with siblings serving as trustees for each other’s trust. In theory, this is a discretionary trust because each beneficiary does not have sole authority to require distributions from his own trust. In practice, the beneficiary compels distribution from his own trust by using his discretion over his sibling’s trust to refuse distribution to the sibling if he/she does not cooperate with the beneficiary. In essence, a quid pro quo is created, whereby “you will receive your funds only if I receive my funds.” Courts have pierced these trusts through the “reciprocal trust” doctrine. This legal doctrine addresses the establishment of similar trusts and unwinding and/or uncrossing them. Bruce D. Steiner and Martin M. Shenkman, “Beware of the Reciprocal Trust Doctrine,” (April 2012) www.trustandestates.com. If the trusts are “un-crossed,” they are treated as a self-settled trust for each sibling. Once treated as self-settled, the income from the trust can be imputed to the beneficiary spouse.

In examining the penetrability of a reciprocal discretionary trust, we need to examine the historical conduct of the parties. For instance: Did the beneficiary select the fund manager? Does he/she dictate the distributions? Have his/her requests been denied? Do all siblings withdraw similar funds for his/her “needs”? As would be expected, the more control the beneficiary exerts over his/her own trust, the less likely that the trust would be considered “discretionary” and out of the beneficiary’s control.

Support Trust

A support trust is a form of discretionary trust that obligates the trustee to make distributions to the beneficiary for her support. In a support trust, the trustee could be required to distribute as much of the net income or principal as is necessary for the beneficiary's health, education, maintenance or support. N.J.S.A. 3B:11-1. The trustee is obligated to make distributions to the beneficiary for her support; thereby removing the trustee's discretion over whether such distributions are necessary for the beneficiary's support. Not only is the trustee's discretion over these distributions removed, but since the beneficiary of a support trust is entitled to receive these distributions, the beneficiary can compel distributions from the trustee of a support trust to the extent those distributions are necessary for his/her support.

The Tannen case presents an example of a "hybrid trust" because it mixes elements of a support trust with a purely discretionary trust. The practical impact is that by attempting to mix uses of support and discretion in creating certain trusts, the estate planner may have weakened both if there is a challenge to the use of funds from the trust.

Impact of Discretionary Trusts on the Supported and the Supporting Spouse

The impact of payment of alimony/child support when one party is a beneficiary of a discretionary trust falls on the supported spouse as well as the supporting spouse, as illustrated below:

Practical Points If You Represent the Non-Beneficiary Spouse

Review the prenuptial agreement to determine if the parties anticipated that all income from all sources would be utilized during the marriage;

Review the tax returns to determine whether the trust income was included in joint tax returns;

Analyze the usage of the trust to determine if it was utilized for essential needs of the marriage, as demanded by the beneficiary spouse;

Analyze the details of the language of the trust to determine whether it is a discretionary trust, a support trust or a hybrid trust;

Analyze the historical transactions, actions of the trustee and the beneficiary to look for actions inconsistent with the terms of the trust;

Determine whether the trust was funded by a third party or whether it was self-settled (in whole or in part); and

Determine whether the trust can be pierced vis-à-vis the “reciprocal trust” doctrine.

Practical Points If You Represent the Beneficiary Spouse

Review the prenuptial agreement for language clarifying that any use of exempt assets (corpus or income) must be considered a nonrecurring “gift” to the marriage and not a part of marital lifestyle;

Determine whether the trust income was ever included in joint tax returns;

Determine whether the trustee consistently followed the requirements of the trust;

Verify that the beneficiary spouse does not exert indicia of control over the trust; and

Determine whether the trust can be pierced on account of the “reciprocal trust” doctrine.

When representing the non-beneficiary spouse, it can be a frustrating task to penetrate the wall created by discretionary trusts. However, if one diligently chips at the wall around the various forms of imperfect discretionary trusts, there is opportunity to argue the appearance of complete discretion is a façade and the trust is an asset that is eligible as a source of imputed income to the beneficiary spouse.

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