

### Planning for a Child's Divorce When Establishing a Trust

Jennifer A. Kosteva, Esquire  
Heckscher, Teillon, Terrill & Sager, P.C.  
Scott J.G. Finger, Esquire  
Hofstein Weiner & Meyer, P.C.

As future spouses contemplate a possible divorce when they enter into a prenuptial agreement, parents of future spouses (which can be any parent) should contemplate their child's potential divorce when establishing a trust for the child's benefit. Parents with a child who is facing a divorce often ask what they can do to protect the child's inheritance from the child's soon-to-be ex-spouse. The best protection that a parent can provide takes place before there is a potential divorce, and even before there is a marriage. As a general rule, Sections 3501(a)(3) and 3501(a) of the Pennsylvania Divorce Code provide that any property that the child (or any married party) acquires by gift, bequest, devise or descent, or property acquired in exchange for such property, is considered to be nonmarital property and not subject to the rules of equitable distribution. However, the increase in the value of any nonmarital property is considered to be marital property.

For example, if a parent leaves \$500,000 to the child outright through his or her estate, and, during the marriage, prior to separation, the \$500,000 appreciates to \$750,000, the child's \$500,000 inheritance would not be treated as marital property. However, the \$250,000 of appreciation on the inheritance and any income from the inheritance could be included in the equitable distribution of marital property and a portion of the appreciation could be awarded to the child's spouse as part of the divorce.

One way to reduce the possibility of having a child's inheritance be reachable in the event of a divorce is to leave the assets to the child in a properly structured trust. In *Solomon v. Solomon*, 531 Pa. 113, 611 A.2d 162 (1992), the Supreme Court of Pennsylvania held that appreciation on trust assets that did not come into the possession or control of the trust beneficiary was neither marital property subject to equitable distribution nor a nonmarital asset. However, once the beneficiary gained sufficient access to the trust assets – in *Solomon*, the right of the beneficiary to withdraw a portion of the trust assets upon reaching age 35 – the appreciation on such portion of the trust assets was deemed to be marital property.

If a child's inheritance is held in a trust for the child's benefit, the child can use the assets only in accordance with the terms of the trust document, which would be administered by one or more trustees. The terms of the trust could be quite flexible, and the child possibly could serve as the sole trustee (or as a co-trustee) of the trust. The goal for the estate planner is to structure the trust in a manner that provides the child significant access to the funds, but not to provide the child with too much ownership or control that would cause the income from or the appreciation on the trust assets to be treated as marital property.

The question becomes what constitutes “ownership and control” for purposes of trust law. Where the language of the trust limits a child’s right to the assets or income of the trust but the trustee is given broad discretion to distribute income and principal, and there is a pattern of acquiescing to any request the child makes to receive assets or income, the issue of “control” becomes more complicated. Similarly, in situations where the child also may be a trustee, a logical argument would say that the child clearly has access and control of the principal and income of the trust. However, inherent in any trustee’s role is the trustee’s fiduciary duty, which prevents him or her from blending the roles of trustee and beneficiary. Therefore, the child’s role as trustee would be deemed to be independent of the child’s role as beneficiary.

To maximize protection in the event of a divorce, the distribution of trust income and principal should remain in the discretion of the trustee pursuant to a so-called ascertainable standard, such as “health, education, maintenance and support” as defined in Internal Revenue Code Section 2041(b)(1)(A) and Treasury Regulation 20.2041-1(c)(2). In *Solomon*, it was the child’s right to withdraw a portion of the trust assets that caused the appreciation on a portion of the trust assets to be treated as marital property. To add flexibility to the trust, an “independent trustee” (generally, a trustee who is not related or subordinate to the child as defined in Internal Revenue Code Section 672(c)) could have the power to make distributions to the child for any purpose. So long as the decision is still within the discretion of the trustee, the child would not be deemed to have access or control. In any event, a mandatory distribution of income, which is commonly included in trusts to take advantage of possibly lower income tax rates, should be avoided, as such distributions could be treated as marital property during the marriage, or income available for support after separation.

The distinction between the child as trustee and the child as beneficiary is a real distinction for purposes of trust law, but some divorce lawyers will caution against having the child serve as the sole trustee of a trust for the child’s benefit. Recent cases such as *Suzanne D. v. Stephen W.*, 65 A.3d 965, 2013 Pa. Super 93 (2013) have been inclined to look at the actual cash flow and resources of parties to a support action, such as in deviating from the support guidelines to consider a regular pattern of receipt of gifts. Therefore, although a trust document and trust law might provide that the child, despite the fact that he or she is also trustee, does not have the right, as beneficiary, to control the continued receipt of income or assets from the trust, a court could consider the regular receipt of trust distributions in fashioning a support award and then only if and when the distributions cease, the distributions would no longer be considered in the support award.

If a child’s divorce is imminent, the parent may wish to consider naming an individual other than the child as trustee, or naming a bank or trust company as trustee. The parent also may consider naming the child as a co-trustee, rather than as sole trustee, so that any trust distributions would require the approval of another, independent, trustee.

In addition to concerns in the context of the divorce, there are other benefits to placing a child’s inheritance in trust that are lost if the inheritance is received outright. For example,

any assets that the child receives outright would be subject to the claims of his or her creditors, just like virtually all of the child's other personal assets. However, inherited assets held in a properly structured trust could not be reached to satisfy such a judgment (although assets to which the child had the right, for example, a mandatory distribution of income, could be available under certain circumstances). Similarly, if the child ever files for bankruptcy, assets the child inherited outright would be used to pay off the child's debts, whereas inherited assets held in a properly structured trust would not; the trust would remain as a safety net for the child after he or she emerged from the bankruptcy process.

In addition, assets that a child inherits outright become a part of his or her own taxable estate. As such, they generally will be subject to federal estate tax, generation-skipping transfer ("GST") tax and state death taxes at his or her death in the same manner that the child's other assets would be subject to such taxes. However, assets held in a properly structured trust, to which a parent allocates his or her GST tax exemption, can pass to the child and the child's descendants free of such death taxes at the child's death.

In establishing a trust for a child's benefit, the settlor parent should consider the balance between providing funds to satisfy the child's needs and ensuring that the assets and income of the trust will be protected against claims by third parties, including creditors and spouses. The key to protecting the income and principal of the trust, in all scenarios, is to ensure that the child's control and access to the principal and income of the trust is limited or restricted.