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Why Some Trusts Crumble and Some Endure During Divorce

Making trusts lawyer-proof in a litigious environment.

By

Amy Feldman

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There's nothing like a nasty divorce to chip away at a family's wealth. Trusts, of course, are the classic tool to protect assets from a grasping spouse, but don't delude yourself into thinking they are fail-proof. Consider the case in which parents put funds into irrevocable trusts for their grown children and hope to shelter their wealth—in the event of a divorce—from the kids' spouses, whom they never liked anyway.

Sadly, it's a rather common assignment for trust lawyers. But caution is in order. The trust "has to be drafted properly so that it doesn't somehow become marital property," says Catherine Taylor, a specialist in trusts and estates at tax and advisory firm Citrin Cooperman.

Generally, assets in a trust that is set up before marriage are exempt from being a marital asset—as long as those funds don't end up being commingled with the marital funds. In the case of divorce, "the nonfamily member will try to make that trust marital property," Taylor says.

When the divorcing spouse can't get at the assets in the trust, the most common argument is that, since the family-related spouse already has so much wealth in a trust, the divorcing spouse should get more of the marital assets than the already well-provided-for spouse. "Equitable distribution doesn't mean half-and-half," says Ilan Hirschfeld, a partner at accounting and advisory firm Marcum, and head of its marital-dissolution practice group.

Another rule of thumb: If the trust is drafted so that the beneficiary can't go to the trustee and demand a distribution, then it is not considered that beneficiary's money. "You can only attach what that person has access to," Taylor says. Also, think twice before taking assets out of a trust.

"As soon as the money leaves the trust—unless there's a prenuptial agreement—the individual has somewhat defeated the trust," says Jeff Ladouceur, SEI Investments' director of private wealth management. "All these things can nibble away at it."

Consider how these nibbling issues played out with Mark and Wendy Tannen, who got divorced after 18 years of marriage, as documented in a New Jersey Supreme Court case. Wendy's parents set up an irrevocable trust for her benefit during her marriage, naming themselves and Wendy as co-trustees. In contention: Should the income from the trust be considered in calculating Mark's alimony obligation? The court ultimately decided it should not.

"The issue was the wife was not able to control the distributions, and since she didn't control them for support purposes, they could rely only on the historical distributions of the trust," says Hirschfeld. (The rules on trusts vary state by state, so you'll want an advisor who knows the case law in your state.)

In another case, Hirschfeld says, a couple set up a trust for their children, and, later, during the divorce, the wife began to question whether her soon-to-be ex-husband's potential future children with his new girlfriend would also qualify for funds. "She wanted language to indicate, 'children of this marriage, and no other marriages,'" Hirschfeld says. The husband, however, refused to change the language of the trust.

Then there's the case in which the husband used funds from a trust—set up for the benefit of his children—to buy himself homes in Colorado and the Bahamas. Hirschfeld says that while such trust funds would normally have been off-limits in the couple's divorce, the wife demanded half of the millions they put into the trust because the whole transaction was a "sham," due to the husband's self-serving real estate purchases.

But taking money out of a trust is never simple, and the husband smartly countered, "Why don't you go tell the kids you're taking money out of the trust? You be the bad mommy."

After much screaming, the man finally gave his ex-wife additional alimony, to reflect what she would have earned on those funds in trust.

Which gets us to our core point. Always remember that a trust isn't just about money, but also about everything else that goes on around it, and that's a particularly important concept to grasp when you're in a litigious environment.

E-mail: penta@barrons.com