
TRUSTS & ESTATES

Clarifying Trusts, Creditors' Rights, And the Related Tax Implications

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UNDER New York's Estates, Powers and Trusts Law "a disposition in trust for the use of the creator is void as against the existing or subsequent creditors of the creator."¹ The statute has been interpreted as denying a settlor protection from creditors where the trust was settled for the exclusive use of the settlor. It is not clear, however, as to whether creditors of a settlor can reach trust assets even if the trustees have absolute discretion to pay nothing to the settlor, and the settlor cannot compel the trustees to make any payments.

*Vanderbilt Credit Corp. v. Chase Manhattan Bank, N.A.*² is most often pointed to as setting forth the law in New York that creditors of a settlor can reach trust assets to satisfy claims where the trustees have discretion to make payments to the settlor.³ There the trust agreement provided that the trustee must pay the settlor all of the net income and that portion of the trust principal as the trustee, in the trustee's discretion, deemed appropriate. The trust agreement declared the trust to be irrevocable and contained a standard spendthrift clause.⁴

In concluding that a creditor could reach that portion of the trust account that constituted trust income, the court applied the general rule that "a property owner cannot utilize a spendthrift trust to insulate his assets from the reach of present or future creditors,"⁵ as codified in EPTL §7-3.1.

As to principal, the court noted that the settlor created a discretionary trust, giving the trustee absolute discretion whether or not to pay principal to the settlor, but concluded that "when a person creates for his own benefit a discretionary trust, his creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply to his benefit, even though the trustee in the exercise of his discretion wishes to pay nothing to the beneficiary or to his creditors, and even though the beneficiary could not compel the

trustee to pay him anything."⁶

The *Vanderbilt* decision strongly implies that its holding with regard to a creditor's ability to reach the trust principal is simply a reiteration of long-standing New York law. It is important to note, however, that in support of its conclusion, the *Vanderbilt* court cites to a Massachusetts case, a Connecticut case, the Second Restatement of Trusts, Scott on Trusts, and notes the contrast to the single case, *Herzog v. Commissioner*,⁷ involving the application of New York law.

In *Herzog v. Commissioner*, the Second Circuit applied New York law to determine whether creditors could reach trust corpus held under a trust agreement that provided that income be paid to the settlor and his wife at the discretion of the trustee, and for the trust remainder to be paid to the settlor's issue after the death of the settlor and his wife. The settlor could not compel any distributions from the trust.

The court observed that, under New York law, a beneficiary of a discretionary trust established by a third party cannot compel the trustee to exercise the trustee's discretion to make a distribution to the beneficiary, and went on to conclude that: "While here the trust was created by the grantor, there is no New York decision holding that the rights of creditors would differ from those available to them in a case where the trust is set up by a third party if the exercise of the power for [the settlor's] benefit is wholly dependent upon the discretion of the trustee" and, therefore, the settlor's creditors could not reach the trust assets.⁸

It is interesting to note that the *Herzog* court was not considering EPTL §7-3.1 (which was enacted 25 years later) or the common law upon which EPTL §7-3.1 was based, but instead cited to New York's Real Property Law §157 and later qualified its earlier statement by stating that "[t]he most that can be said ... is that the law of New York respecting the right of [the settlor's] creditors to reach the income of the trust is in doubt."⁹

Herzog is also unusual in that it ignores at least one New York case that should have served as precedent. In *Liberty Storage & Warehouse Co. v. Van Wyck*,¹⁰ the trust agreement provided that income be paid to the settlor, that upon written request the settlor could receive up to \$5,000 annually from principal with the consent of the trustee, and that the settlor could exercise a

testamentary power of appointment over 25 percent of the trust corpus. Upon the settlor's death 75 percent of the trust assets would be paid to named remaindermen but if the settlor lived past Nov. 26, 1943, the settlor could revoke the trust.

The settlor's creditors maintained that under the Personal Property law then in effect (which is currently embodied in EPTL §7-3.1) they could reach 25 percent of the trust corpus to satisfy their claims. In denying the creditors' claims, the court explained that the Personal Property law was intended to codify the common law that dated back to the mid-1800s, which provided that only conveyances in trust "wholly or primarily" for the use of the settlor were void against creditors.¹¹

Here the remaindermen had a vested contingent interest in 75 percent of the trust and, therefore, the settlor's interest was only incidental to the remaindermen's interest and the settlor's creditors could not reach the trust corpus. Had the court in *Herzog* considered *Liberty Storage*, it might have concluded that since income and principal of the trust created by the settlor in *Herzog* was not "wholly or primarily" intended to benefit the settlor, it was already established under New York law that the settlor's creditors could not reach the trust assets.

Therefore, despite the *Vanderbilt* court's apparent contention to the contrary, the status of New York law was unclear regarding the question of whether a settlor's creditors could reach trust assets where the trustees have discretion to use trust assets for the benefit of the settlor. The *Vanderbilt* court's conclusion has important federal estate and gift tax implications.

Federal Transfer Tax Impact

Section 2036 of the Internal Revenue Code (Code) provides that the gross estate includes the value of all property over which the decedent "has retained for his life ... the possession or enjoyment of, or the right to the income from, the property, or the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or income therefrom." Additionally, §2038 of the Code provides that the gross estate includes all property over which the decedent retained authority "to alter, amend,

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revoke, or terminate" an interest in the property. Taken together, §§2036 and 2038 stand for the proposition that property transferred to a trust is includible in the settlor's estate if the settlor retains excessive rights or powers with respect to the transferred property.

The Internal Revenue Service (Service) has considered whether a settlor's transfer of property to a discretionary trust constitutes a completed gift for gift tax purposes if the transferred property remained subject to the claims of the settlor's creditors.

In Revenue Ruling 76-103 the Service held that a transfer did not constitute a completed gift under §2511 as long as the trust property remained subject to the claims of creditors under state law. However, the Service noted that "[i]f and when the grantor's dominion and control of the trust assets ceases, such as by the trustee's decision to move the situs of the trust to a State where the grantor's creditors cannot reach the trust assets, then the gift is complete for Federal gift tax purposes"

The ruling went on to state that "if the grantor dies before the gift becomes complete, the date of death value of the trust corpus will be includible in the grantor's gross estate, for Federal estate tax purposes, under section 2038 of the Code because of the grantor's retained power to, in effect, terminate the trust by relegating the grantor's creditors to the entire property of the trust." Thus, under the rationale of Revenue Ruling 76-103, if the creditors of the settlor of a trust have the power to satisfy judgments against the settlor out of trust corpus, the initial transfer of the property to the trust will not be subject to gift tax and the trust assets will be includible in the settlor's gross estate,¹² likely under both §§2036 and 2038 of the Code.¹³

A. The Service's Interpretation of New York Law Prior to 1984. As noted above, in *Herzog* the Service was successful in asserting its position that the initial gift to the trust was complete for gift tax purposes and gift tax was due on all of the property transferred to the trust. In Revenue Ruling 77-378 we see that, in keeping with *Herzog*, prior to 1984 the Service had taken the position that under New York law a transfer of property to an irrevocable trust, under the terms of which the trustee has discretionary power to distribute income and principal to the settlor, constitutes a completed taxable gift of the entire value of the property transferred. This of course results in gift tax upon the funding of the trust but no estate tax upon the death of the settlor.

Similarly in the estate tax context, where a trust agreement provided that the trustees had complete discretion to pay or apply part or all of the principal and net income of a trust for the support and benefit of the descendants of the settlor's mother (including the settlor), the Service has concluded that the trust corpus is not includible in the settlor's estate under §2036 of the Code.¹⁴

Finally, in Technical Advice Memorandum 8213004, which addressed both the gift and estate

tax, the Service concluded, based on *Herzog*, that under New York law, where a trustee had discretion to pay income to the settlor and principal to the settlor's spouse, the initial gift to the trust was complete, for gift tax purposes, and the trust corpus was not includible in the settlor's taxable estate under §2038 of the Code.

In assessing whether the trust corpus was includible in the settlor's estate, however, the Service did not rely on *Herzog* or the logic later set forth in Revenue Ruling 76-103, as one would have expected, but instead turned to that line of cases, which includes *Liberty Storage*, limiting the application of EPTL §7-3.1 to cases where the trust was created for the sole benefit of the settlor. In the case to which the T.A.M. was directed, the trustees had discretion to make payments to the settlor's spouse as well and, therefore, EPTL §7-3.1 did not apply to void the trust against creditors of the settlor.¹⁵ Because creditors could not reach the trust corpus, it was not includible in the settlor's taxable estate under §2038 of the Code.

B. The Service's Interpretation of New York Law After 1984. Although the *Vanderbilt* court did not discuss the gift or estate tax ramifications of its holding, under *Vanderbilt* the creditors of a settlor can reach trust assets where the trustees have discretion to make payments to the settlor. Based on this, one would conclude that the settlor's transfer to a trust is incomplete for gift tax purposes, and the trust corpus is includible in the settlor's taxable estate. This conclusion is, of course, inapposite to the holdings in *Herzog* and *Liberty Storage*.

In *Estate of Paxton v. Commissioner*¹⁶ the Tax Court addressed the issue of whether certain property transfers by the decedent to two trusts were includible in his estate under §§2033, 2036, 2037, or 2038. In a footnote the court stated:

Since *Herzog v. Commissioner*, 116 F.2d 591 (2d Cir. 1941), aff'g 41 B.T.A. 509 (1940), was decided, the New York courts have come to accept the Restatement rule as the law in that State. See *Vanderbilt Credit Corp. v. Chase Manhattan Bank*, 100 A.D. 2d 544, 473 N.Y. Supp. 2d, 245-246 (1984), where the court stated: "when a person creates for his own benefit a discretionary trust, his creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply to his benefit, even though the trustee in the exercise of his discretion wishes to pay nothing to the beneficiary or to his creditors, and even though the beneficiary could not compel the trustee to pay to him anything."¹⁷

Apparently, the Tax Court understands New York law subsequent to *Vanderbilt Credit Corp.* to allow the settlor's creditors to reach the assets of such a trust. This would mean that any transfer to such a trust is incomplete for gift tax purposes and any assets held in such a trust will be includible in the taxable estate of the settlor.

Conclusion

In cases where a trust under which the settlor is a discretionary beneficiary was funded prior to 1984,¹⁸ one could have reasonably taken the position that the gift was complete and subject to gift tax at the time the trust was funded because, under the then-governing case law, the settlor's creditors could not reach the trust assets.¹⁹

If such a trust was settled after 1984, in light of the decision in *Vanderbilt* and the Service's comment in *Paxton* it seems clear that the Service would take the position that the settlor's creditors can reach the trust assets. Therefore, the Service would contend that the initial funding of such a trust should not be subject to gift tax and the trust corpus should be subject to estate tax upon the settlor's death.

(1) N.Y. Est. Powers & Trusts Law §7-3.1(a).

(2) 473 N.Y.S.2d 242 (2nd Dept. 1984).

(3) See, e.g., *United Presbyterian House at Syosset, Inc. v. Lincks*, New York Law Journal, March 3, 2003, p.28, col. 3 (Supreme Court, Nassau County).

(4) Such a clause prevents the beneficiary from assigning income to a third party and is intended to assure that trust income cannot be reached by the beneficiary's creditors. Under current law, all trusts are assumed to be spendthrift trusts unless the instrument specifies otherwise. See N.Y. Est. Powers & Trusts Law §7-1.5(a)(1).

(5) *Vanderbilt*, 473 N.Y.S.2d at 245.

(6) *Id.* at 245-46. The court pointed out that it might have found that both income and principal were reachable by *Vanderbilt Credit Corp.* under a fraudulent conveyance theory, but in light of the reasoning described above resulting in *Vanderbilt* reaching all of the trust assets, it did not need to prove fraudulent conveyance.

(7) 116 F.2d 591 (2nd Cir. 1941).

(8) *Id.* at 594.

(9) *Id.*

(10) 256 A.D. 641, 11 N.Y.S.2d 92 (1st Dept. 1939).

(11) See also *In re Boume's Will*, 158 N.Y.S.2d 1009 (Sur. Ct. Suffolk Cty. 1957).

(12) See also *Outwin v. Commissioner*, 76 T.C. 153 (1981); *Paolozzi v. Commissioner*, 23 T.C. 182 (1954); see also Rev. Rul. 77-378, 1977-2 C.B. 347 (holding that if, under state law, the settlor's creditors cannot reach the trust assets, then the gift is complete for gift tax purposes).

(13) See T.A.M. 199917001 (May 1999); see also *Outwin*, 76 T.C. 153, 168 n.5.

(14) P.L.R. 8037116 (June 23, 1980).

(15) See also P.L.R. 8213004 (Dec. 7, 1981) (concluding that the trust corpus was not includible in the settlor's estate because the trust was not solely for the use of the creator within the meaning of EPTL §7-3.1); P.L.R. 7833062 (stating that "[s]ection 7-3.1 ... is applicable only where the settlor is the sole beneficiary of the trust.").

(16) 86 T.C. 785 (1986).

(17) *Id.* at 816 n.29.

(18) Whether a gift is complete for gift tax purposes is determined based upon the law in effect at the time the transfer was made. See Treas. Reg. §25.2511-2(a),(b). Therefore, even if creditors could currently reach the trust corpus, if they could not reach it at the time the gift was made, the gift was complete and the trust corpus would not be includible in the settlor's taxable estate.

(19) Whether the trust assets will be includible in the taxable estate of the grantor will depend, at least in part, upon whether *Vanderbilt* had retroactive or only prospective effect for tax purposes.