Creditor Access to a Beneficiary's Trust

Many clients ask us about leaving assets to a child (or other beneficiary) in a way that protects the assets from creditor and spousal access. This may be because a child is not financially responsible, is in an unstable marriage or is in a high-liability profession. Generally, leaving assets to a child in a so-called irrevocable "spendthrift" trust, rather than outright, makes those assets harder for a third party to access. A spendthrift trust includes a clause that prohibits the beneficiary from assigning away his or her inheritance, and it also protects against a creditor accessing the inheritance to satisfy a judgment against the beneficiary. Without a spendthrift clause, a beneficiary's interest in a trust can be voluntarily or involuntarily transferred. Most irrevocable trusts include a boilerplate spendthrift clause.

A recent California Supreme Court case (Carmack v. Reynolds) provides further planning guidance. The Court concluded that if a creditor has a legal judgment against a beneficiary, the creditor can reach trust assets that are "due and payable," but not yet distributed, to the beneficiary, except for trust assets that are specifically earmarked and actually needed for the beneficiary's support or education. Trust assets that are "due and payable" are those that the trustee is required to distribute to the beneficiary. If the assets that are due and payable are not sufficient to satisfy the creditor's judgment, the creditor can levy up to 25 percent of the distributions expected to be made to the beneficiary in the future, subject to certain offsets, including anticipated support needs for the beneficiary.

By way of illustration, if the beneficiary of an irrevocable spendthrift trust is entitled to receive an automatic distribution of $10,000 on March 1, 2018, and on each March 1 thereafter for 10 years, and if a creditor has a legal judgment under which the beneficiary owes the creditor $50,000, on March 1, 2018, the court may require the trustee to pay the $10,000 distribution directly to the creditor. The court could approve an additional future payment to the creditor of $22,500 (25% of each of the remaining nine $10,000 distributions as they come due). To collect the remaining amount due under the judgment, on each subsequent March 1, the court can further require the trustee to pay the balance of that year's $10,000 distribution (or $7,500) until the judgment is fully paid.

The Court's ruling provides valuable guidance in drafting the distribution requirements of an irrevocable spendthrift trust where creditor access is of a particular concern. For example, a fully discretionary trust (that is, it provides for no mandatory distributions), or a trust limiting mandatory distributions to those needed for support and education only, may be appropriate. In addition, it may be appropriate to limit a beneficiary's broad (or "general") lifetime or testamentary power of appointment over trust assets.

Of course, these restrictions must be balanced with the other tax and non-tax costs and benefits of the trust. They may not make sense in every situation. Also, it is important to note that a judgment for child support or spousal support, or a lien for unpaid taxes, is subject to more generous access rules.

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