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Avoiding Appreciation in Trust Assets Being Treated as Marital Property

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In drafting trust documents, the attorney should be sensitive to the potential inadvertent treatment of interest in the trust as marital property. In advising a trust beneficiary who is contemplating marriage, an enforceable marital agreement can be used to address the operation of marital rights on the trust beneficiary's interest.

Drafting Trusts to Avoid Marital Rights

The economic reality of possession of a power of appointment over trust assets is becoming more and more determinative in analyzing its legal consequences. Accordingly, Colorado case law reflects a trend toward the analysis of trusts, for purposes of their characterization as "property" in connection with the division of property in a dissolution of marriage proceeding, under the same type of analysis to which trusts are subjected in determining whether they are included in a decedent's taxable estate for federal estate tax purposes, as well as for other purposes.

Under Internal Revenue Code ("Code") § 2041, if the decedent is found to possess a lifetime general power of appointment, the trust assets are included in the decedent's taxable estate. Similarly, under CRS § 15-11-201(2)(b)(I)(A), lifetime general powers of appointment are included in a decedent's augmented estate for purposes of calculating a spouse's elective share rights.

A power of appointment can exist by virtue of either an express and unrestricted right to withdraw trust assets or the power to revoke and revise the trust. A "power of appointment" has been historically characterized as a right affecting ownership, and not technically as "property."

While the Colorado courts have not specifically addressed the issue of treatment of a trust as property of a spouse who has a lifetime general power of appointment over the trust assets, they have operated under the unmistakable assumption that placing property in a trust will not necessarily place it beyond the reach of a spouse in a dissolution action.

Colorado Cases Dealing With Trusts

In *Kaladic v. Kaladic*,[1] the Colorado Court of Appeals held that a trust created by a spouse was illusory and a sham, fraudulently intending to avoid rights with respect to a spouse. In contrast, the court, in *In re Marriage of Rosenblum*,[2] held that the increase of value of assets in a discretionary trust created by a third party was not marital property in a situation where the spouse-beneficiary was acting as co-trustee, because the spouse's powers as trustee were limited by an ascertainable standard of "health, education, support and maintenance." This is consistent with the tax treatment of such trusts. More recently, in the case of *In re Marriage of Jones*,[3] another discretionary trust created by a third party was reviewed by the Colorado Supreme Court. If the spouse had served as trustee, the court held, the spouse's powers as trustee were limited by an ascertainable standard.

The trusts were not treated as separate property under either *Rosenblum* or *Jones*; thus, the appreciation in trust assets during marriage was not marital property. However, in neither case did the spouse have a general power of appointment. In *Jones*, the court did comment on the impact on the treatment of trusts of the seminal cases of *In re Marriage of Gallo*[4] and *In re Marriage of Grubb*.[5] The *Gallo* and *Grubb* decisions signaled a generally more expansive, and less technical, view of "property" in the dissolution context, specifically in treating retirement rights as property for division of property purposes.

The court in *Jones* indicated that it would not address whether vested rights in a trust subject to divestment (such as a lifetime general power of appointment) would be either marital or separate property. The court noted a split of authority in the various jurisdictions on this issue and cited the Massachusetts case of *Davidson v. Davidson*.[6] Significantly, since *Davidson* was decided, the Vermont Supreme Court in *Lynch v. Lynch*,[7] citing *Davidson*, held that a right to revoke a trust caused the trust to be "property" for purposes of an equitable division of property on dissolution of marriage.

While neither *Rosenblum* nor *Jones* deemed the trusts involved to be "property," the trusts were treated as an "economic circumstance" to be taken into consideration in the property division. Such treatment may have yielded a result not much different from the trust being considered "property" for division of property or maintenance purposes, although the spouse did not have a lifetime general power of appointment in either case.

Of further interest in *In re Marriage of Footit*,[8] the Colorado Court of Appeals held that the income of a trust was marital property. While not mentioned in the court's opinion, in *Footit*, the trust terminated by its terms at age thirty-five. Because the spouse had reached the age of thirty-five, she had a "right" at any time to have the trust assets distributed to her. This is no different in substance than a trust granting a spouse an unrestricted lifetime general power of appointment and would explain the spouse's tactical decision in *Footit* not to contest the issue of the status of the trust as separate property.

Colorado Decisions Involving Other Types of Property Interests

Additional Colorado cases dealing with other types of interests and rights support the expectation that, if the issue were directly addressed, Colorado courts would hold that a lifetime power of appointment will cause a trust to be treated as the "property" of the power holder for purposes of a property division in a dissolution action.

In *In re Marriage of Fields*[9] and in *In re Marriage of Vogt*,[10] a personal injury claim and a contingent fee, respectively, were held to be property for purposes of a division of property in a dissolution action. Technically, neither right is "property." One is a cause of action; the other is a contractual right. At the other end of the spectrum, in *Graham v. Graham*,[11] the Colorado Supreme Court recognized that the definition of property under CRS § 14-10-113(2) is broad, but held that it would not apply to a college education.

The Colorado Supreme Court in *Gallo*, in its analysis with respect to military pay, in overruling *In re Marriage of Mitchell*,[12] rejected the assumption by the court in *Rosenblum* that the concept of "property," as applying to trusts, would be given a more narrow and technical meaning. Under *Gallo* and *Grubb*, Colorado courts are required to look beyond technical forms of ownership of general property law, and to consider the true substance and "economic reality" of the interest or right involved, including whether it is "speculative." Thus, if assets are potentially available to a spouse because of a right or interest held by that spouse, they have been treated as "property" for purpose of division of assets, regardless of their ownership form.

The absence of ascertainable standards for trust distributions for estate tax purposes under Code § 2041 causes a trustee-beneficiary's discretionary distribution powers to be considered as creating a general power of appointment for estate tax purposes. In *Rosenblum*, the court noted that the husband had used the assets of the trust on occasions as if he were the sole owner, despite the inclusion of ascertainable standards in the trust document. Query whether, in light of the court's analysis in *Gallo* and *Grubb*, *Rosenblum* would be decided differently today, on a showing that the ascertainable standards in a trust were in reality a meaningless sham. In the bankruptcy context, in *In re Flanzbaum*,[13] this issue was handled in a fashion similar to piercing the corporate veil.

Properly, the application of the *Rosenblum* and *Jones* decisions should at least be limited to situations where a trustee's powers are restricted by an ascertainable standard, the spouse does not otherwise have a lifetime general power of appointment for tax purposes, and the facts do not indicate that the trust was really a sham.

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Creditors' Rights

The Law of Trust[14] § 147.3 states that a general power of appointment is not subject to creditors' rights unless it is exercised. *University National Bank v. Rhoadarmer*[15] held that a creditor cannot force the exercise of a power to withdraw the greater of $5,000 or 5 percent of trust corpus each year. However, spouses have frequently been recognized to have greater rights than a creditor for property division purposes, based on a strong public policy in favor of the protection of spousal rights.

In *In re Baum*,[16] a bankruptcy case, the court held that under Colorado law, assets in a discretionary trust were not subject to the claims of creditors. The court expressly relied on the fact that the settlor was not the sole beneficiary and did not have the power to revest the property in himself, clearly implying that the existence of a lifetime general power of appointment would produce a different result, even in the context of the rights of a nonspouse creditor.

Analysis

The fact that a right may be subject to divestment on death (as is true of a power of appointment) should not make a difference in its treatment for marital rights purposes. This was true with respect to retirement and pension rights in *Grubb* and *Gallo* and should likewise be true with respect to a bank account that is set up POD or a securities account set up TOD. The only practical difference between these rights and a lifetime power of appointment is that the holder of the general power of appointment may not have the right to designate the recipient of the property at death if the power is unexercised.

The same analysis should apply where a spouse is acting as trustee and has an unrestricted and unlimited right as trustee to distribute trust assets to himself or herself (that is, the trustee's discretion is not limited by an ascertainable standard), even if an express power of appointment is not granted. In this case, a general power of appointment would

exist for both federal estate tax and income tax purposes, unless another trustee who has significant adverse interest in the trust also is acting.

Generally, if the spouse is given lifetime rights that would cause the trust to be included in his or her taxable estate, the trust should be treated as property for purposes of division of property on dissolution of marriage. The sole exception might be a testamentary power of appointment. However, because the holder of the testamentary power could possibly sell his or her right to exercise the power (assuming a spendthrift provision was not included), the appropriate issue might be one of valuation, rather than treatment of the trust assets as property, with the *Gallo* case providing guidance on this issue. Logically, if the testamentary power holder is not the sole lifetime beneficiary, the value will be nominal.

Summary

As a practical matter, in drafting to avoid spousal claims to trust assets for property division purposes, no more rights should be given to a beneficiary of a trust than would be granted if it was desirable to preclude the beneficiaries' interest from being subject to federal estate taxes and the trust from being included in the power holder's augmented estate. In the case of a trust beneficiary contemplating marriage, the issue can be specifically addressed in a properly drafted and executed marital agreement. The drafting attorney should inquire as to the existence of trust rights and consider the need to address such rights in a marital agreement. The second part to this article discusses the enforceability of such agreements.

Enforceable Marital Agreements

Enforceability of a marital agreement will depend on the date the agreement was entered, whether the agreement was entered before or after marriage, and the circumstances surrounding its execution. The Colorado Marital Agreement Act ("CMAA")[17] governs both prenuptial and postnuptial agreements signed after July 1, 1986. The Colorado Act was based on, but varies from, the Uniform Premarital Agreement Act, which dealt exclusively with premarital agreements. The CMAA requires the signature of both parties to a marital agreement.

Rights at Death

CRS § 15-11-207 and its predecessors govern waiver of marital rights at death (such as the spousal elective share, the family and exempt property allowances, homestead rights, and the right to appointment as personal representative).[18] The provisions of CRS § 14-2-307 on enforceability are expressly made applicable to a waiver of rights at death of a spouse under CRS § 15-11-207. Contrary to the CMAA, CRS § 15-11-207 allows an effective waiver of rights at death to be signed by only the party waiving his or her rights.

Consideration

The common law requirement of consideration for a contract to be binding is not applicable to agreements governed by the CMAA, which merely requires the signature of both parties. For pre-CMAA agreements, consideration is necessary, but is deemed to exist with respect to a marital agreement either by virtue of the contemplated marriage (as to prenuptial agreements) or by virtue of mutual waiver of rights (as to both prenuptial and postnuptial agreements). Thus, contrary to pre-CMAA agreements, under the CMAA a postnuptial agreement signed after July 1, 1986, could be enforceable, even if there is not a mutual waiver of rights, as long as the agreement is signed by both spouses.[19]

Unconscionability

With respect to a waiver of rights relating to a division of property under the CMAA (for post-July 1, 1986, prenuptial and postnuptial agreements), the unconscionability test is not applicable, although principles of fairness, full disclosure, and the absence of fraud, sharp-dealing and overreaching (at the time of signing the agreement) would still operate in considering the validity of such agreements. Parties to such an agreement are, if they are married, in a fiduciary relationship with each other, creating additional obligations of such things as fairness.[20] Further, all marital agreements are contracts, subject to the common law concepts of enforceability governing contracts.[21] Thus, it can be argued that the applicability of the unconscionability test is really a distinction without a difference.

Under the CMAA, unconscionability as of the time of enforcement of the agreement is still the applicable test for validity of provisions waiving maintenance, as opposed to property rights, on dissolution of marriage. Under *Newman*, the same rules would govern pre-CMAA prenuptial agreements. However, *Manzo* indicates that (contrary to the rule under *Newman* as to prenuptial agreements) unconscionability still applies as a test with respect to postnuptial agreements entered into prior to July 1, 1986. *Manzo* relied on both general principles of contract law, as well as CRS § 14-10-112, in its decision applying an unconscionability test to such agreements.

The Act's deletion of an unconscionability test for property division applies to all post-CMAA postnuptial agreements, provided such agreements are executed prior to the time of filing a dissolution of marriage action. Under CRS § 14-10-112, unconscionability still applies as a test to agreements signed after a marriage dissolution action is commenced.

Specificity

For any waiver of rights to be effective, it must be specific. *In re Estate of Smith*,[22] which dealt with spousal rights at death, held that a statement that the spouse agreed with the Will of the decedent did not constitute a specific enough waiver of "all rights" in the event of death under the statute to be effective. *Smith* reflects the strong public policy frequently expressed by the courts in favor of protecting marital rights.

The case of *In re Marriage of Stokes*,[23] which dealt with the issues of property division and maintenance, also required a specific recitation of marital rights as a prerequisite to an effective waiver of such rights. A waiver of "future acquisitions" was found in *Stokes* to be sufficient to waive rights to future appreciation of separate property, while the absence of a specific reference to "maintenance" made the agreement inoperable as to these rights. The general principle that any agreement should be construed most strictly against the drafter of that agreement also should operate in the case of an agreement containing ambiguous or nonspecific waiver of marital rights.

In *In re Marriage of Simon*,[24] because the agreement did not address the characterization of proceeds as marital or separate, the court noted as *dictum* that, even if the agreement had been a "marital agreement" for purposes of the CMAA, it was not a specific enough waiver of rights to affect the status of property (in that case, settlement proceeds) as marital or separate. Although a personal injury settlement agreement with a third party was signed by both spouses in *Simon*, the spouse apparently conceded the agreement was not a "marital agreement" for property division purposes.

Legal Representation and Disclosure of Assets

The issues of the effect of legal representation and fair and reasonable disclosure on property and financial obligations under marital agreements are not changed by the CMAA. With respect to the impact of the existence of independent legal advice on the enforceability of a marital agreement, the cases of *In re Marriage of Ingels*,[25] *In re Marriage of Ross*,[26] and *In re Estate of Lopata*[27] all held that the absence of legal representation did not make the agreement invalid. However, the court's consideration of the issue in these cases reflects that it is certainly a factor that can be a consideration in an agreement being found invalid.

Disclosure of assets also clearly has a bearing on the validity of such agreements. With respect to "fair disclosure," some cases, such as *Lopata*, discuss "general knowledge" of "approximate values" as the criteria for fair disclosure.

Lopata involved the issue of rights at death, where the Dead Man's Statute foreclosed the surviving spouse's testimony in the absence of disclosure. It should be limited in application accordingly. In *In re Marriage of Rahn*,[28] evidence of a spouse's general knowledge of the husband's assets and that a pension plan was "specifically described" was held to be a sufficient disclosure. In *Ross*, mentioned above, the court stated that detailed, written financial statements were not required, but left open the question of the degree of specificity and accuracy of information required for full and fair disclosure. *Newman*, also mentioned above, defined the requirement as necessitating "a high degree of fairness and disclosure of all circumstances which materially bear on the antenuptial agreement." [*Citations omitted.*] Obviously, the standard for disclosure as articulated by the courts remains nebulous, making it best to err on the side of providing more, rather than less, detail.

Summary

The events and circumstances surrounding the signing of a marital agreement can be as important as its contents in determining its enforceability. Both aspects of such agreements require special attention and precautions to protect a marital agreement from a later attack.

NOTES

1. 589 P.2d 502 (Colo.App. 1978).

2. 602 P.2d 892 (Colo.App. 1979).

3. 812 P.2d 1152 (Colo. 1991).

4. 752 P.2d 47 (Colo. 1988).

5. 745 P.2d 661 (Colo. 1987).

6. 474 N.E.2d 1137 (Mass.App. 1985).

7. 522 A.2d 234 (Vt. 1987).

8. 903 P.2d 1209 (Colo.App. 1995).

9. 779 P.2d 1371 (Colo.App. 1989).

10. 773 P.2d 631 (Colo.App. 1989).

11. 574 P.2d 75 (Colo. 1979).

12. 579 P.2d 613 (Colo. 1978).

13. 8 B.R. 971 (Bkrptcy. Fla. 1981).

14. Scott and Fischer, *The Law of Trust* (4th Ed. 1987).

15. 827 P.2d 561 (Colo.App. 1991).

16. 22 F.3d 1014 (10th Cir. 1994).

17. CRS § 14-2-301 *et seq.*

18. *See also* CRS § 14-2-304(2).

19. Carraher, *The Colorado Marital Agreement Act*, 1993 DU College of Law Advanced Estate Planning Symposium.

20. *In re Marriage of Newman*, 653 P.2d 728, 732 (Colo. 1982); *see also In re Estate of Lopata*, 641 P.2d 952 (Colo. 1982).

21. *In re Marriage of Young*, 682 P.2d 1233 (Colo.App. 1984); *Marriage of Newman*, *supra*, note 20; *In re Marriage of Manzo*, 659 P.2d 669 (Colo. 1983).

22. 674 P.2d 972 (Colo.App. 1983).

23. 608 P.2d 824 (Colo.App. 1979).

24. 856 P.2d 47 (Colo.App. 1993).

25. 596 P.2d 1211 (Colo. 1979).

26. 670 P.2d 26 (Colo.App. 1983).

27. *Supra*, note 20.

28. 914 P.2d 463 (Colo.App. 1995).

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