Discerning the true settlor of a trust

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The person designated in the terms of a trust as its settlor (creator) may not necessarily be its true settlor (creator). Appearances are often deceiving in the world of the trust. Charles E. Rounds, Jr. explains in §8.43 of *Loring and Rounds: A Trustee's Handbook* (2013). The section is reproduced below in its entirety.

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§8.43 Who Is the Settlor of the Trust?

[Excerpted from Charles E. Rounds, Jr, *Loring and Rounds: A Trustee's Handbook* (2013), at pages 1293-1295]

> *A somewhat different question may arise when a will fails to provide for one or more heirs, who contest or threaten to contest the will and obtain a compromise, under which there is a spendthrift trust for the heirs' benefit. It has been held in such a case that the heirs are settlors of the trust, and that their creditors can reach their interests*.[1]

One would be hard pressed to sort out whether the creditors of the beneficiary of a trust can reach the equitable interest and/or the underlying trust property,[2] or even the tax liabilities of the parties to the trust relationship,[3] without knowing who the settlor is.[4] If, for example, the trust is

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[1] 3 Scott & Ascher §15.4.4.

[2] *See generally* §5.3.3.1 of this handbook (reaching settlor's reserved beneficial interest).

[3] *See generally* §8.9.3 of this handbook (tax-sensitive powers); Chapter 10 of this handbook (the income taxation of trusts).

[4] Bogert, Trusts and Trustees §41 ("The identity of the settlor may be of practical importance in applying certain rules governing trusts; examples are the rule that a spendthrift provision is not valid to protect the interest of the settlor of a trust [*see generally* §5.3.3.1 of this handbook]; the rule permitting a settlor to revoke a voluntary trust with the consent of all persons beneficially interested [*see generally* §8.2.2.1 of this handbook]; the statutes and regulations that enumerate

self-settled, that is, if income and/or principal, initially at least, is to be administered solely for the benefit of the settlor, then for purposes of fixing the rights of creditors and the tax liabilities of the parties, it is as if the settlor-beneficiary owned the underlying trust property outright and free of trust.[5] Usually who the settlor is self-evident; but not always. The settlor is the one whose property has been entrusted. It is not necessarily the one who has been designated as settlor in the governing trust documentation.[6] Nor is it necessarily the one who conveyed legal title to the trustee.[7] And in cases where there have been multiple transfers of property to the trustee over time by different settlors, as to each transferor the trust can be said to be partially self-settled. But which part?

First, it borders on the self-evident that if X, as authorized agent of A, transfers A's property to B, as trustee, A is the settlor, not X.[8] This is the case even if X happens to have had the legal title.[9] A, for example, might purchase some stock from a broker and direct the broker to transfer the stock to B, as trustee, for the benefit of whomever. A is the settlor, not the broker.

A participant in a company-sponsored defined benefit or defined contribution employee benefit plan is the settlor of his or her allocable portion of any entrusted assets, even that which is attributable to employer contributions.[10] Essentially, it the employee's own property rights incident to the employment contract that are being entrusted.[11] It would be nonsensical to suggest that the employer is making gratuitous transfers in trust of its own property for the benefit of its employees.

Or take a civil award of damages for some personal injury done to an infant that by court order is being held in trust for the benefit of the infant, even an infant who is severely brain damaged. It is the infant, not the court,[12] not the infant's guardian, who is the settlor of the trust, whatever the governing documentation may say.[13] Neither the court nor the guardian owned the subject property. At all times, the property was owned by the infant. Accordingly, any income generated by the entrusted property is taxable to the infant, not to the court or to the guardian personally, and potentially reachable by the infant's creditors, unless there is some statute to the contrary.

Assume that A1 and A2 simultaneously establish identical inter vivos trusts purporting to be for one another's benefit. A compelling equitable argument, however, can be made that the trusts

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available resources for purposes of determining eligibility for certain public assistance programs [*see, e.g.*, §5.3.5 of this handbook (Medicaid eligibility)]; or for other reasons.").

[5]*See generally*§5.3.3.1 of this handbook (reaching settlor's reserved beneficial interest).

[6]*See generally* 3 Scott & Ascher §15.4.4.

[7]*See generally* 3 Scott & Ascher §15.4.4.

[8]*See generally* 3 Scott & Ascher §15.4.4.

[9]*See generally*§9.9.2 of this handbook (agency arrangements) (noting in a footnote that an agent-trustee takes legal title to the property that is the subject of the agency).

[10]*See generally* 3 Scott & Ascher §15.4.4.

[11]*See generally*§9.5.1 of this handbook (the employee benefit trust (tax qualified)).

[12]One commentator, however, has suggested that the settlor of an express trust established by court decree can be the court itself. *See* Bogert, Trusts, and Trustees §41. That one is deemed to be the settlor of an express trust by statute or by its terms does not make one the actual settlor. The actual settlor of an express trust is the one whose property is entrusted. Thus, for a "court" to qualify as the actual settlor of an express trust, the "court" would have to have been the owner of the subject property in its own right and to have had the authority to impress a trust upon it, a most unlikely set of facts.

[13]*See generally* 3 Scott & Ascher §15.4.4; §9.3 of this handbook (the self-settled "special needs"/"supplemental needs" trust).

are actually self-settled. The argument is that A1, as settlor, has in equity established for his own benefit a trust the property of which is a collection of rights incident to a contract with A2, and vice versa. The contract is to impress trusts upon the subject properties. In creating the trusts, each is acting as an agent of the other in fulfillment of his or her contractual obligations. This substance over form analysis is at the heart of the reciprocal trust doctrine.[14] In the estate tax context, however, there need not be a contract for the doctrine to be implicated. "Instead, its application requires 'only that the trusts be interrelated, and that the arrangement, to the extent of mutual value, leaves the settlors in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries.'"[15]

When there have been incremental self-settled transfers of property into trust over time by different transferors, each transferor is deemed the settlor of that portion of the trust that is attributable to his or her contribution.[16] (This would be the case even if the transfers were not for the benefit of the transferors.) But equitably determining what that portion is may not be all that easy if, for example, some of the transfers were in kind and others in cash; or if over time there have been unequal discretionary distributions of principal to some but not all the beneficiaries; or if a beneficiary has used his or her own funds to make substantial improvements on the trust property; or if a beneficiary has used his or her own funds to pay off a mortgage on the trust property.[17] If A1 transfers a parcel of real estate to the trustee of a discretionary trust that has multiple settlors, then A1's creditors may well have access at least to that parcel, provided it is still in the trust. At least one court has so held.[18]

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[14]*See generally*§8.15.24 of this handbook (reciprocal trust doctrine).

[15]3 Scott & Ascher §15.4.4 (citing to United States v. Estate of Grace, 395 U.S. 316, 324 (1969).

[16]*See generally* 3 Scott & Ascher §15.4.4. *See also* Bogert, Trusts and Trustees §46 (but also leaving the impression that a third party who takes trust property from the trustee in fair market exchange or substitution for other property would be a settlor as to that other property, which is not the law).

[17]*See generally* 3 Scott & Ascher §15.4.4.

[18]In re Shurley, 115 F.3d 333 (5th Cir.), *cert denied*, 522 U.S. 982 (1997).