

Domestic Asset Protection Trusts



© Copyright 2001-2009

Merric Law Firm, LLC
All Rights Reserved



Merric Law Firm, LLC

4155 E. Jewell Ave., Suite 500
Denver, CO 80222
(303) 300-0243; (303) 800-4369 Skype
Mark@InternationalCounselor.com
www.InternationalCounselor.com

Mark Merric, JD, MT, CPA In addition to being an attorney, Mark Merric holds a Masters of Taxation and he is a Certified Public Accountant, as well as an Adjunct Professor at the University of Denver's, Law School Graduate Tax Program. He has been quoted in Forbes, Investor's News, On the Street, the Denver Business Journal, Oil and Gas Investor, and the Sioux Falls Business Journal. Mr. Merric is a manager for Merric Law Firm, LLC and the Alliance of International Legal Counselor, LLC. Prior to practicing as an attorney, Mark Merric developed a strong business background working for a Final Four Accounting Firm.

Mr. Merric presents nationwide more than 30 times annually. He is honored to have spoken at:

- Regis Campfield's Notre Dame Tax and Estate Planning Institute (2007);
- Lonnie McGee's Southern California Tax and Estate Planning Forum, (2006), (2007), and (2008); and
- Chicago Bar Association (2004), (2007), (2008), and (2009).

Mark Merric has been fortunate to be one of the few authors that have had three, four, and five part series published in Estate Planning Magazine, Journal of Practical Estate Planning, and Leimberg LISI. He is also a co-author of the following three treatises:

- The Asset Protection Planning Guide: A State-of-the-Art Approach to Integrated Estate Planning, Commerce Clearing House (CCH) treatise, first edition;
- Asset Protection Strategies, American Bar Association (two chapters); and
- Asset Protection Strategies Volume II, American Bar Association to be published Apr. 2005 (MM responsible for 1/5 of the text).

Table of Contents

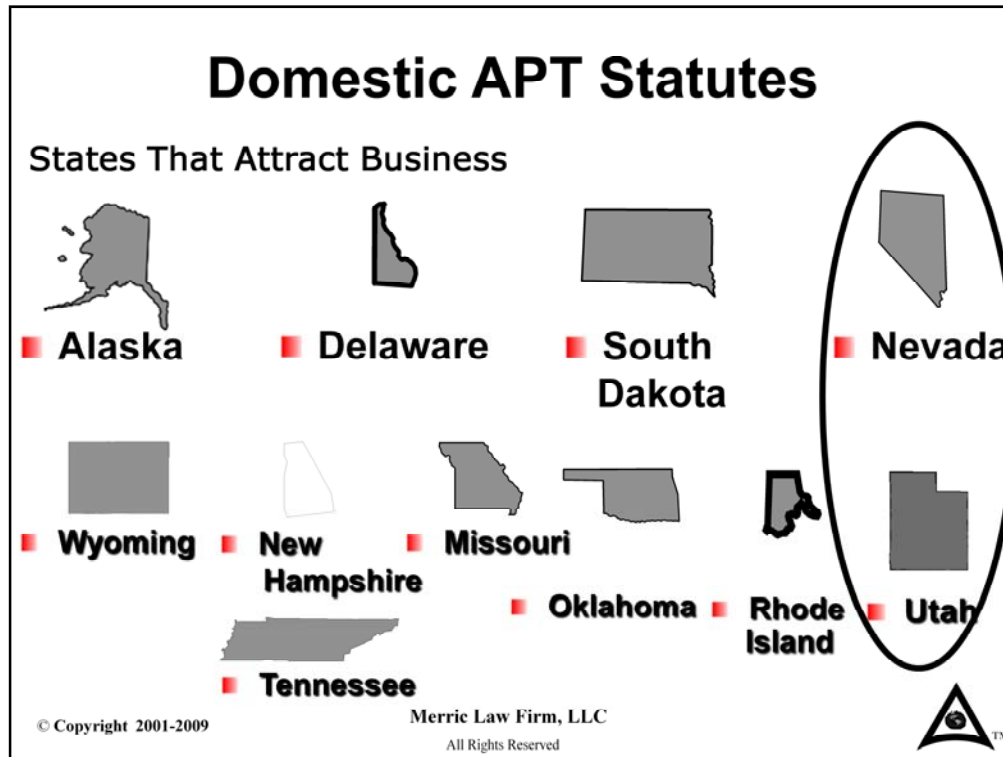
A.	Domestic APT Statutes	4
B.	UTC States	5
1.	Missouri UTC	6
2.	Wyoming UTC	7
3.	New Hampshire UTC	8
4.	Tennessee	9
5.	Restatement Third Affect on Other States	11
C.	Tax Neutrality	12
D.	Asset Protection Concerns with Domestic APTs	13
1.	Full Faith and Credit Clause	13
2.	Supremacy Clause	14
E.	Weighing the Factors	15
F.	Factors to Consider When DAPT Foreign Shopping	16
1.	What Types of Trusts Qualify?	17
2.	How Does a DAPT Statute Work – Fraudulent Conveyance	18
3.	Bankruptcy Act and APTs	20
4.	Forcing the Litigation Into the DAPT State	21
5.	Protection of Advisors	22
6.	Flexibility Your May Wish to Avoid	23
G.	Domestic APT States That Attract Trust Business	25
H.	Effectiveness of a DAPT for Out of State Residents	26
I.	Why Offshore APTs Are More Protective	27
J.	Self Settled Estate Planning Trust	30
1.	Estate Inclusion Issues and the Estate Planning Octopus™	31
2.	Three Tentacles to IRC § 2036	31
3.	IRC § 2036(a)(1) – Life Interest Rule	33
4.	Analogy to a Constitutional Trust	36
5.	Offshore APTs	37
6.	Domestic APTs	38
a.	Non-Resident Estate Inclusion Issues	39
b.	Exception Creditors & IRC § 2041	40
c.	Exception Creditors & IRC § 2036	49
d.	Federal Claims	51

Co-Counsel

Due to the large number of seminars, webinars, and articles that we publish as well as the liability that is involved, we are unable to respond to specific e-mail or telephone calls on client facts unless we are involved in a co-counsel basis. For further information on the type of co-counsel engagements that we accept go to www.internationalcounselor.com/Services.htm.

Disclaimer

The law is constantly changing at an unprecedented pace. Also, each client's separate fact situation must be carefully examined before applying any principals of law. Furthermore, this outline is not intended to be a substitute for the practitioner's own research into this area of law and how the law applies to a client's specific situation. Therefore, the author takes no responsibility how the areas of law covered by this outline apply to the reader or the reader's clients. Finally, to ensure compliance with requirements imposed by the IRS Circular 230, we hereby inform you that any U. S. tax advice contained in this communication is not intended or written to be used, and cannot be used for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any matter addressed herein.



A. Domestic APT States

1. History

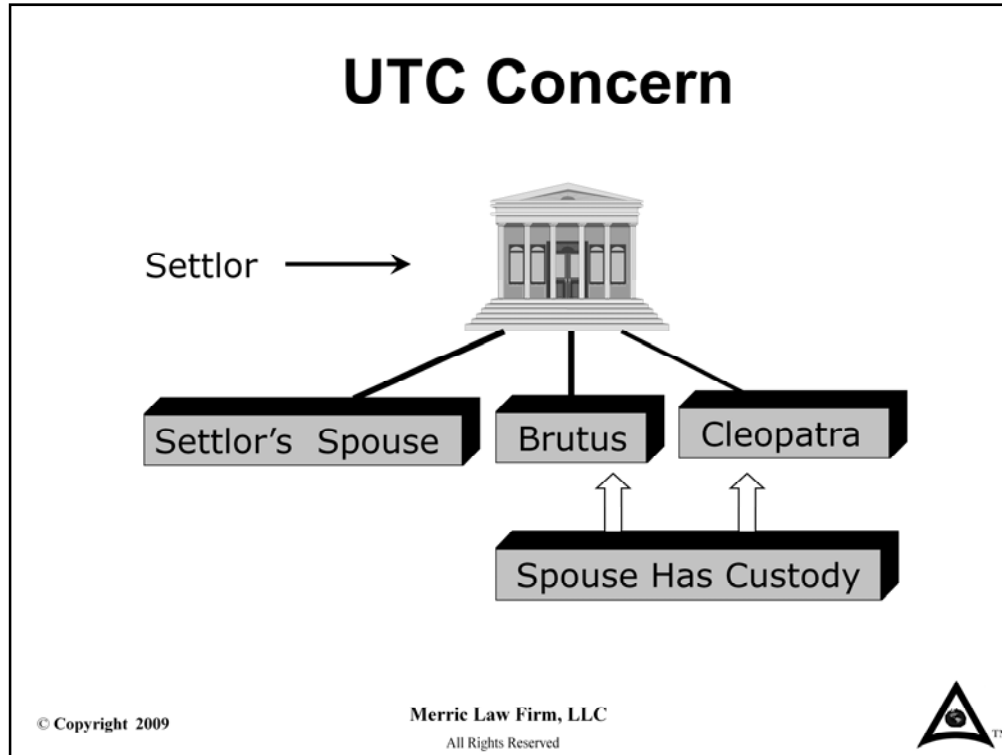
After eighteen nations had passed offshore asset protection trust legislation, in 1996 Alaska passed the first domestic APT legislation, followed by Delaware in 1997. Now there are eleven states that have passed asset protection statutes, with New Hampshire being the latest addition in 2008.

2. States That Attract Trust Business

Four states, Alaska, Delaware, Nevada, and South Dakota, have emerged as the leaders in domestic APT statutes. An analysis of many of the important asset protection issues of these four statutes follows after a discussion of concerns with domestic APTs. When forum shopping from a non-domestic APT state, these are states that one should consider to site a domestic APT.

3. States That Are Used Primarily Within The State

Missouri, Wyoming, and Tennessee have domestic APT statutes, but are also Uniform Trust Code States. There are concerns regarding the legal effect of a discretionary trust in these states are discussed on the next few pages. Oklahoma's DAPT statute is limited to \$1 million deposited in an Oklahoma bank. Rhode Island entered the race coming out of the gate with a strong statute, but has not amended it over the years to keep pace with the leaders, and Utah has nine exception creditors combined with the UTC discretionary trust issues.



B. UTC States

The UTC made significant deviations from the common law regarding the asset protection of a beneficial interest. Under common law, a discretionary interest was neither an enforceable right to a distribution or a property interest, and no creditor, not even an exception creditor, could attach the interest. The Restatement Third redefines a discretionary trust so that almost all beneficiaries will have an enforceable right to a distribution, and consequentially hold a property interest. There is considerable debate whether the UTC adopts the Restatement Third position, even after amendment in 2005.

Assume that the beneficiary has an enforceable right to a distribution, the settlor has named himself and his minor children as beneficiaries, and the settlor is divorced. Having absolutely nothing to do with child support, alimony, or a division of marital property, may an estranged spouse who has custody now sue for a distribution on behalf of a minor child? Of course, he or she can, and if the minor child has an enforceable right to a distribution, the court will order the distribution.

With divorce rates at over 50%, estranged spouses are probably one of the more critical persons to worry about. In this respect, this is a major issue to be dealt with. In addition to not using certain UTC states when forum shopping, some additional suggestions that have been proposed are to use highly discretionary trust language or to only allow discretionary distributions to the settlor. The highly discretionary language may solve the issue. Conversely, restricting distributions to the primary beneficiary (i.e. the Settlor), may make it more likely for an out of state court to find dominion and control and not apply the DAPT state law. See Merric, *Drafting Discretionary Dynasty Trusts Part III*, Estate Planning Magazine April 2009.

Attempts At Addressing the UTC Concerns?



■ **Missouri**



■ **Wyoming**



■ **Tennessee**



■ **New
Hampshire**

© Copyright 2009

Merric Law Firm, LLC
All Rights Reserved



1. Missouri UTC

There are three parts to codifying the discretionary asset protection provided by the Restatement Second and addressing the enforceable right issue: (1) defining a discretionary trust interest; (2) stating the legal effect of a discretionary interest (i.e. the beneficiary does not have an enforceable right or a property interest); and (3) providing a judicial review standard that does not create an enforceable right. The Missouri UTC defines a discretionary interest in MS. 456.5-504 by reference to 456.5-506. While this definition may not be the model of clarity when compared to the South Dakota's discretionary – support statute, the proposed Michigan UTC, or the Wyoming UTC, the definition of a discretionary trust is somewhat clear. Regarding the second factor, the Missouri UTC was specifically modified to address some of the enforceable right issues under the UTC. M.S. 456.5-504 states that a “a beneficiary’s interest in a trust that is subject to the trustee’s discretion does not constitute an interest in property or an enforceable right . . .”

Unfortunately, the Missouri UTC does not adequately address the third factor. The judicial review standard may conflict with both the definition of a discretionary interest as well as whether the beneficiary of a discretionary interest has an enforceable right. MS. 456.5-814 1. states, “Notwithstanding the use of such terms as “absolute,” “sole,” or “uncontrolled,” in the exercise of discretion under an ascertainable standard, the trustee shall exercise such discretionary power in good faith . . .” So if a discretionary interest does not have any element of an ascertainable standard, does a beneficiary have less of an enforceable right to a distribution. Conversely, this section seems to be implying that if there is an ascertainable standard a beneficiary actually does have an enforceable right to a distribution. The “good faith” standard and enforceable right issue are discussed more in detail under the New Hampshire UTC.

In addition to the enforceable right issue, the Missouri UTC does **not** have the following more protective DAPT features of the other lead trust jurisdictions:

- a. Fraudulent conveyances limited to “defraud,” instead of “hinder, delay, or defraud;”
- b. No date of discovery rule for future creditors;
- c. Burden of proof is “clear and convincing” evidence;
- d. Asserting exclusive jurisdiction over APTs;
- e. Automatic removal of trustees; or
- f. The protection of advisors.

2. Wyoming

In addressing the enforceable right issue under the UTC, Wyoming has provided a good definition of a discretionary trust. Wyo. St. § 4-10-103 (xxix). Unfortunately, the Wyoming UTC does not state the legal effect of a discretionary interest. Does a beneficiary have an enforceable right or not? Regarding the judicial review standard, due to the ambiguity of a “good faith” standard, the Wyoming UTC eliminated § 814(a). However, the Wyoming statute is now silent on whether it retains the dual judicial review standard under the Restatement Second that prevents the enforceable right for a discretionary interest. For a further discussion of this issue see Merric, *Drafting Discretionary Dynasty Trusts Part II*, Estate Planning Magazine, March 2009.

In addition to the enforceable right issue, the Missouri UTC does **not** have the following more protective DAPT features of the other lead trust jurisdictions:

- a. Fraudulent conveyances limited to “defraud,” instead of “hinder, delay, or defraud;”
- b. No date of discovery rule for future creditors;
- c. Burden of proof is “clear and convincing” evidence;
- d. Asserting exclusive jurisdiction over APTs; or
- e. Automatic removal of trustees.

3. New Hampshire

The New Hampshire Uniform Trust Code provides that subject to a good faith standard of review, the beneficiary of a discretionary trust has neither a property interest nor an enforceable right, but holds only a mere expectancy. N.H. Rev Stat. § 564-B:8-814. The New Hampshire approach that codifies part of the discretionary protections of a common law is a bit confusing as well as possibly internally inconsistent. First unlike common law, §§ 501 through 504 of the New Hampshire UTC does not prevent attachment of a discretionary interest. This leads to the question, if a beneficiary does not have a property interest under § 814, what type of interest did the exception creditors attach to under § 503? Also, if a beneficiary does not have a property interest or an enforceable right under § 814 and the trust did not contain a spendthrift provision, how could any creditor attach a non-interest under § 501? Further, § 814 would imply that if a judge found that a distribution should be made in good faith for whatever reason, the beneficiary now has an enforceable right and a property interest.

As noted in Mark Worthington’s, *The Impact of the Uniform Trust Code on Third Party Special Needs Trusts*, NAELA Annual convention 2006 outline Black’s Law Dictionary (6th Ed.) said that “good faith [has] no technical or statutory meaning” and defined “bad faith” as the opposite of “good faith.” The 8th Edition under a new editor does not say that, but says the concept is “elusive,” quoting from Brownsword’s “Good Faith in Contracts.”

Mr. Worthington's outline details many problems and possible interpretations created for discretionary trusts when the UTC uses a one "good faith" judicial level standard of review, instead of the dual judicial common law standard of review. This outline may be downloaded at: <http://www.internationalcounselor.com/NAELAInstitute2006%20-%20Worthington.pdf>

In addition to the enforceable right issue, the New Hampshire UTC does **not** have the following more protective DAPT features of the other lead trust jurisdictions:

- a. Fraudulent conveyances limited to only "defraud," instead of "hinder, delay, or defraud;"
- b. Burden of proof is "clear and convincing" evidence;
- c. Asserting exclusive jurisdiction over APTs; or
- d. Automatic removal of trustees.

4. Tennessee

While the other three DAPT UTC states have recognized and provided an attempt to address the enforceable right issue under the UTC, Tennessee has not yet addressed this issue.

In addition to the enforceable right issue, the New Hampshire UTC does **not** have the following more protective DAPT features of the other lead trust jurisdictions:

- a. Fraudulent conveyances limited to only "defraud," instead of "hinder, delay, or defraud;"
- b. Burden of proof is "clear and convincing" evidence;
- c. Asserting exclusive jurisdiction over APTs; or
- d. Protection of trust advisors.

Support Trust

My Trustee shall make distributions to the beneficiaries listed in Section 1.07 for health, education, maintenance, and support.

Discretionary Distribution Standard – Restatement (Second) of Trusts

My Trustee may pay to or apply for the benefit of any one or more of the beneficiaries listed in Section 1.07 as much of the net income and principal as the trustee determines in his sole and absolute discretion for his or her health, education, maintenance, support, comfort, general welfare, an emergency, or happiness.

Discretionary Distribution Standard – Common Law

My Trustee may pay to or apply for the benefit of any one or more of the beneficiaries listed in Section 1.07 as much of the net income and principal as the trustee determines in his sole and absolute discretion for his or her health, education, maintenance, support, comfort, general welfare, an emergency, or happiness. The Trustees, in their sole and absolute discretion, at any time or times, may exclude any of the beneficiaries or may make unequal distributions among them.

Discretionary Distribution Language After the Restatement (Third) of Trusts

My Trustee may distribute as much of the net income and principal as my Trustee, in its sole, absolute, and unfettered discretion, determine to any beneficiary listed in Section 1.07. My Trustee, in its sole, absolute, and unfettered discretion, at any time or times, may exclude any of the beneficiaries or may make unequal distributions among them. Also, my Trustee, in its sole discretion may distribute all of the income and principal of this Trust to one of the beneficiaries and exclude all other beneficiaries from any of the Trust Property. The power to make a distribution in my Trustee's sole, absolute, and unfettered discretion includes the power to withhold making a distribution to any beneficiary in my Trustee's sole, absolute, and unfettered discretion.

In keeping with the wholly discretionary nature of this trust and all separate trusts created hereunder, no beneficiary, except as regards to any irrevocable vesting in the beneficiary's favor, shall have any ascertainable, proportionate, actuarial or otherwise fixed or definable right to or interest in all or any portion of any trust or its property. It is my intent that the trustee have all of the discretion of a natural person, and that a distribution beneficiary holds nothing more than a mere expectancy. It is also my intention that the above language be interpreted as to provide my Trustee with the greatest discretion allowed under law.

Distributions made to a beneficiary under this Article shall not be considered advances and shall not be charged against the share of such beneficiary that may be distributable under other provisions of this agreement. Any undistributed net income shall be accumulated and added to the principal of the trust."

Note: Many trust companies will have problems accepting the above language.

Restatement Third's Affect on Other States

- **Strong Second Restatement Law**
 - Pohlman – Nebraska vs
 - Ohio

- **Statute Codifying the Restatement Second**
 - South Dakota
 - Proposed Michigan UTC

© Copyright 2009

Merric Law Firm, LLC
All Rights Reserved



5. Restatement Third's Affect on Other States

One might ask is the above divorce issue a threat in other states that might in the future adopt the Restatement Third's new position regarding discretionary trusts. This will probably depend on a few factors. First, does the state have strong common law adopting the Restatement Second of Trusts view? If so, there is always the possibility that a court will adopt the Restatement Third's view, but it is less likely. If a state has no or little discretionary-support trust law, naturally there is a greater chance the state courts will be unaware of the major change in trust law created by the Restatement Third and adopt the Restatement Third position. Naturally, the best solution is to adopt a statute that codified the Restatement Second position by statute. To date, South Dakota has a strong statute that squarely addresses the problems created by the Restatement Third. It also has addressed many of the dominion and control issues. The proposed Michigan UTC has also done likewise. Other states are currently contemplating copying parts of the South Dakota statute to address some of these Restatement Third problems.

Tax Neutrality Asset Protection Trust

- For purpose of the beginning part of this outline
- Grantor Trust For Income Tax Purposes
- Incomplete Gift For Gift Tax Purposes
- Included in Settlor's Estate

© Copyright 2001-2009

Merric Law Firm, LLC
All Rights Reserved



B. Tax Neutrality

1. Grantor Trust

Pursuant to IRC 673, 674, 676, 677, the trust will be classified as a grantor trust for tax purposes. Sections 673, 676, and 677 apply because the settlor is generally a beneficiary of the trust. Section 674 applies because the settlor holds both an inter vivos and testamentary power of appointment.

2. Incomplete Gift

Since the settlor holds an inter vivos and a testamentary power of appointment, pursuant to Treas. Reg. Section 25.2511-2(c), the gift is incomplete for tax purposes.

3. Estate Tax

The property has never been transferred for gift tax purposes so it is still included in the settlor's estate under Section 2033. Alternatively, Section 2036(b) would apply – the power to designate beneficial enjoyment.

Non-Resident Concerns With Domestic APTs

- No case law
- Conflict of Laws –
 - Full Faith & Credit
 - Hanson v. Denckla
- Supremacy Clause



© Copyright 2001-2009

Merric Law Firm, LLC
All Rights Reserved



D. Asset Protection Concerns With Domestic APTs

At present, these statutes are untested, and thus there has been considerable debate among the different promoters of onshore v. offshore trusts as to whether these trusts do in fact work. Naturally the onshore promoters say they do, and the offshore promoters say they don't. The offshore promoters have two main arguments regarding Constitutional issues that surround these trusts:

- a. Full Faith and Credit Clause; and
- b. Supremacy Clause.

1. Full Faith and Credit Clause

Under the full faith and credit clause, unless there is a strong public policy reason for not doing so, a sister state is required to respect another sister state's judgment. Therefore, if a California court held that a creditor could reach a Settlor/beneficiary's interest in an Alaskan trust, an Alaska court should respect the California judgment. Conversely, there is also a strong chance the Alaska courts will not respect the California judgment, under the public policy argument that a settlor/beneficiary's interest should not be subject to attachment. The result is this issue may well need to be decided by the U.S. Supreme Court.

a. *Hanson v. Denckla*, 357 US 235, reh'g denied, 358 US 858 (1958).

Some proponents of domestic APTs have cited the U.S. Supreme Court case of *Hanson v. Denckla* as authority that under the full faith and credit clause the domestic APT law will be applied. This case appears to be miscited. It is true that the original Delaware case and Florida case decided the issue under the conflict of law principles and each state came to the opposite conclusion over whose laws governed a revocable trust; Delaware held it was valid while Florida held it was against public policy. It is also true that the full faith and credit argument was brought in front of the U.S. Supreme Court. Yet, the Supreme Court decided the case under personal jurisdiction, not the full faith and credit clause.

In *Hanson v. Denckla*, a Delaware bank who was the trustee of the revocable trust never solicited any business in Florida by direct contact or mail, had no branch bank in Florida, and did not transact any business in Florida. None of the revocable trust assets were located in Florida. Hence, the U.S. Supreme Court held that Florida did not have personal jurisdiction over the Delaware trustee, since there were no minimum contacts under the doctrine of *International Shoe v. Washington*, 326 U.S. 310 (1945).ⁱ

Today, few (if any) domestic APT trust companies would not meet the personal jurisdiction requirements of *International Shoe*. Therefore, the proposition that *Hanson v. Denckla* supports the proponents of domestic APTs claims that the law of the situs of the trust will be applied is completely misplaced. Again, *Hanson v. Denckla* was decided under whether a Florida court had jurisdiction, not which state laws would control under a conflict of laws case.

b. *National Shawmut Bank v. Cummings*, 91 NE2d 337 (Mass 1950).

Also frequently miscited as supporting the full faith and credit clause argument in favor of domestic APTs is *National Shawmut Bank*. In *National*, the Massachusetts Supreme Court applied conflict of law principles to decided the case in favor of the Massachusetts revocable trust. The case was never heard by the U.S. Supreme Court, so no decision was ever rendered under the full faith and credit clause.

2. Supremacy Clause

At first glance, within the context of bankruptcy, the supremacy clause of the U.S. Constitution appears to be particularly detrimental. Generally, a bankruptcy court must apply the law of the state it sits in. *Butner V. United States*, 440 U.S. 48 (1979). If this were the case, domestic DAPTs would provide little, if any, asset protection to a non-DAPT resident in the bankruptcy context. Yet, as contrary authority see *In re Remington*, 14 B.R. 496 (D.N.J. 1981). The Bankruptcy Court in *Remington*, held that as applied to a New Jersey bankrupt, the state law of as to be determined by the Pennsylvania courts regarding spendthrift protection of certain Pennsylvania trusts should be applied.

ⁱ In his treatise, *Commentary on Conflict of Laws*, 3rd Edition, the Foundation Press, Inc., Russell Weintraub notes that “*Hanson v. Denckla* was the first modern Supreme Court case to invalidate a state’s exercise of jurisdiction.”

Factors a Judge May Consider?



- Governing law of trust
- Residence of settlor
- Place of Administration
- Residence of beneficiaries
- **Location of the Assets**

© Copyright 2001-2009

Merric Law Firm, LLC
All Rights Reserved



E. Weighing the Factors

As a general statement, it is much more likely that a judge from a non-DAPT state will apply the law of the DAPT state if most of the trusts contacts are with the DAPT state. Peter Spero and Duncan Osborne have suggested the following factors that a non-DAPT court may consider:

- (1) Governing law of the trust;
- (2) Place of administration (Residence of the Trustee);
- (3) Location of the Trust Property;
- (4) Residence of the Settlor;
- (5) Residence of the Beneficiaries; and
- (6) Any other factor.

A similar list of factors was used by the Kansas Appellate Court to determine the most “significant relationship” for purpose of conflict of laws under the UTC. In *Commerce Bank v. Bolander and Whittet*, 2007 WL 1041760 (Kann. App. 2007) unpublished opinion.


Factors to Consider When DAPT Forum Shopping?

- What Type of Trusts are Protected
- How do the statutes work?
– fraudulent conveyance
- Forcing the Litigation to the DAPT state
- Protection of Advisors

F. Factors to Consider When DAPT Forum Shopping

While the above factors are in no sense all inclusive of what one should consider when forum shopping for DAPTs, they provide an outline of most of the major factors.

What Type of Trusts Qualify? Irrevocable Trusts

Alaska	Delaware	South Dakota	Nevada
Distribution of Income:			
All	All	All	Discretionary Only
Distribution of Principal:			
Discretionary, Support, And almost all mandatory	Discretionary, Support, And almost all mandatory	All	Discretionary Only
<small>© Copyright 2006-2009</small>	<small>Merric Law Firm, LLC All Rights Reserved</small>		

1. What Type of Trusts Qualify – Irrevocable Trusts

Under common law, there were primary three types of trusts: (1) discretionary trusts, (2) support trusts, and (3) mandatory trusts. With a discretionary trust, a beneficiary does not have an enforceable right or a property interest. The beneficiary holds nothing more than a mere expectancy. Almost all states' common law permit a discretionary trust to be coupled with a distribution standard. With a support trust, a beneficiary has an enforceable right to a distribution based on the standard in the trust, and with a mandatory trust a beneficiary has an absolute right to the distribution.

Almost all APTs are drafted as discretionary trusts due to the superior asset protection of a common law discretionary trust over spendthrift provisions.ⁱ In this respect all lead DAPT states protect a discretionary trust. Alaska, Delaware, and South Dakota also protect a support trust. This brings up a key point with Nevada APTs. The drafter needs to be absolutely certain what qualifies as a discretionary trust under Nevada law. This is a bit problematic because the case law on discretionary trusts in Nevada is quite sparse.

All lead DAPT statutes, except Nevada, protect distributions from a QPRT and a CRUT. On the other hand, Delaware limits GRAT and Unitrust protection to 5%. Therefore, in these states any excess shall be subject to creditor attachment. Alaska protects all interests in a GRAT, CRUT, or Unitrust. Finally, South Dakota protects all mandatory interests.

ⁱ For a detailed discussion regarding the superior protection of a common law discretionary trust, see pg. 2 of the outline detailing the procedures to download the discretionary dynasty trust outline at www.InternationalCounselor.com.

a. Alaska

Alaska's statute should protect a support interest under common law. AS 34.040.010 (b)(3) states that the income interest is protected "unless part of the trust income or principal must be distributed." The authors would hope that a judge would interpret the words "must be distributed" to mean only a mandatory distribution interest, not a support interest.

b. Delaware:

Delaware's statute also appears to have a little ambiguity in it. The resolution of the conflicting provisions may result in a support interest not being protected under the statute. 12 Del. Code § 3570(10)(b)(3) states: a trust is not considered revocable on account of inclusion of . . . "the transferor's potential or actual receipt of income, including rights to such income retained in the trust instrument." Standing by itself, it appears that this sentence protects the following distribution interests: (1) mandatory distribution interests; (2) support interests; and (3) discretionary interests. However, if this is the case, why are split interest trusts also given protection in 12 Del. Code § 10(b)(4), (5), & (8) if these interests were already protected. Also, why is principal only protected to the extent of a "substantially unfettered right." Furthermore, what is a "substantially unfettered right?"

c. South Dakota

South Dakota has two statutes that protect DAPTs. First, under its traditional DAPT statute modeled after the Delaware statute and SB 98. SB 98 protects all three distribution interests in trusts: (1) discretionary interests; (2) support interests; and mandatory interests. Therefore, due to its second and overlapping DAPT statute, South Dakota does not have the ambiguity as discussed in the Delaware trust statute as well as it is the only state that protects all types of distribution interests.

d. Nevada

Nevada appears to allow only for the protection of a discretionary interest. N.R.S. 166.040 (2)(b) states that for a self-settled trust it must be irrevocable and does not "require a distribution to the settlor if he may receive it only in the discretion of another person." A support interest is an enforceable right held by any beneficiary. Therefore, it appears that a support interest may well not be protected under the Nevada statute.

How does a DAPT Stand Alone Statute Work: Fraudulent Conveyance

Alaska	Delaware	South Dakota	Nevada
Defraud (no hinder or delay) only & Specific Creditor			
Yes	Yes	Yes	No
Length for Present Creditors:			
Present 4/1	Present 4/1	Present 3/1	Present 2/6mo
Length for Future Creditors:			
Future 4 yr	Future 4 yr	Future 3 yr	Future 2 yr
Burden of Proof:			
Clear & Convincing	Clear & Convincing	Clear & Convincing	3. Act Silent
Merric Law Firm, LLC <small>All Rights Reserved © Copyright 2006-2009</small>		Bankruptcy Code = 10 Years	

2. *How Does a DAPT Statute Work – A Fraudulent Conveyance Action is the Creditor’s Sole Remedy*

Qualified disposition style DAPT laws typically provide that, unless a creditor is an exception creditor, the only claim that a creditor may bring is a fraudulent transfer action. Control and dominion arguments are precluded by this sole remedy fraudulent conveyance approach. Therefore, each DAPT states’ fraudulent transfer law becomes important.

A standard fraudulent conveyance rule allows avoidance of any transfer that “hinders, delays, or defrauds” a creditor. While direct authority regarding “hinder and delay” is sparse, what little exists indicates that transfers can “hinder” or “delay” without involving fraud. Hence, Alaska and Delaware have a competitive edge over all other DAPT states on this point.

In Alaska, Delaware, and South Dakota, a present creditor must bring an action within four years of the transfer or one year of learning of the discovery of the DAPT. However, in these three jurisdictions, a future creditor must bring an action within four years from the date the property is conveyed to a DAPT or the claim is forever barred. Hence, there is no “date of discovery” rule available for future creditors. This differs from the approach of the Uniform Fraudulent Transfer Act (“UFTA”) that allows future and present creditors in an “actual fraud” case to invoke a “date of discovery” rule for purposes of determining when limitations periods commence.

For comparison, note that Nevada has a two year primary limitations period, and only allows 6 months for certain creditors to invoke “date of discovery” tolling rules. Nevada’s shorter date of discovery rule gives it an edge over all states on this point. However, Nevada’s advantage may be neutralized in bankruptcy, as the Bankruptcy Code imposed a ten year limitations period in connection with certain fraudulent transfer claims against self-settled DAPTs and other vehicles.¹

In determining whether a fraudulent conveyance has occurred, a plaintiff’s quantum of proof can be important. Delaware and South Dakota statutorily impose an elevated “clear and convincing” standard. Wyoming’s DAPT statute is silent on this point, so normal UFTA rules probably apply. Yet, there is very little case law on this point, although at least one case indicates that plaintiffs must prove a fraudulent transfer claim by clear and convincing evidence.

a. Alaska

Except for Alaska’s APT statute, almost all, if not all, states use the term “hinder, delay, or defraud” any creditor in their fraudulent conveyance statutes. The Alaska statute uses only “defraud that creditor.” Presumably the “term” means that specific creditor. AS Code §34.40.010(b)(1).

Statute Limitations: AS Code § 34.40.100(d)(1) & (2).

No judgment from another jurisdiction: AS Code § 34.40.110(k).

Burden of Proof: As Code § 34.40.100(d)(1)(i).

b. Delaware

Length: 6 Del. Code §1309 & 12- Del.Code § 3572(b).

No judgment from another jurisdiction: 12 Del. Code § 3572(a).

Burden of Proof: 12 Del. Code § 3572(b).

c. South Dakota

Length So.Dak. Code §54-8-A-9 & So. Dak. Code §55-16-10(2).

No judgment from another jurisdiction. So. Dak. Code § 55-16-13.

Burden of Proof So. Dak. Code § 55-16-10.

d. Nevada

Length N.R.S. § 166.170 (1) and (2)

Burden of Proof - none mentioned in statute; no reference to fraudulent conveyance act so assumed to be a preponderance of the evidence.

ⁱ 11 U.S.C. § 548(e)(1).

Bankruptcy Act & APTs

- 10 year statute if intent is to hinder, delay, or defraud a creditor – Section 548
 - Same requirement for a homestead

Go to pg. 20

© Copyright 2005-2009

Merric Law Firm, LLC
All Rights Reserved

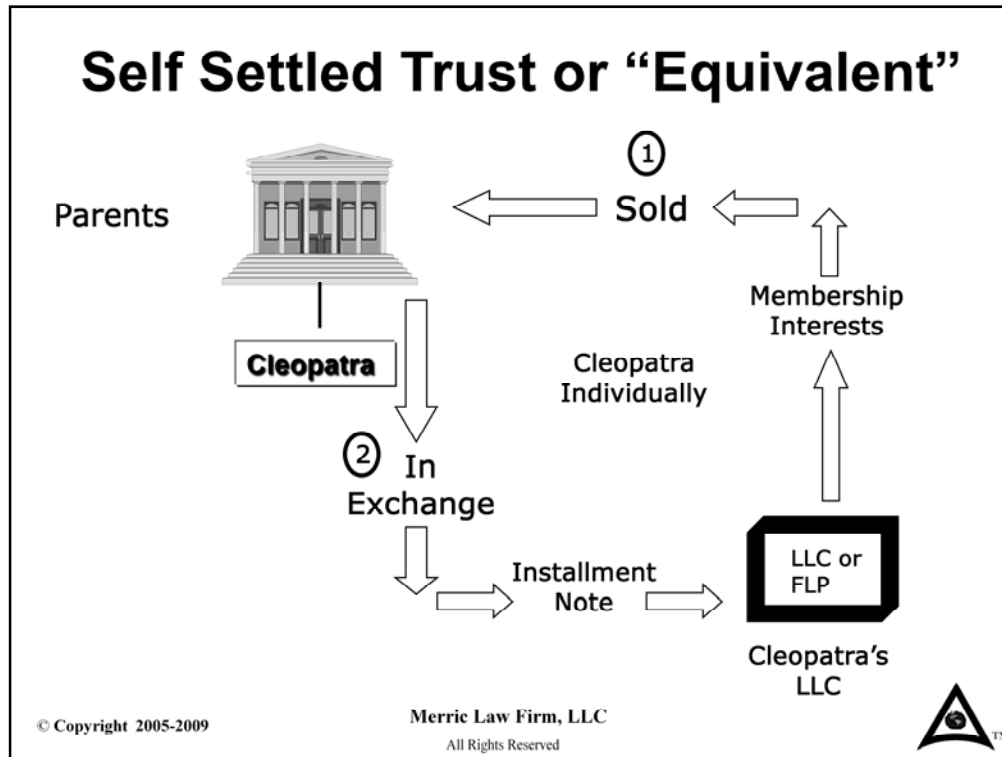


3. *Bankruptcy Act and APTs*

a. *Overview*

The new Bankruptcy Act extends the statute of limitations to ten years for a Bankruptcy Trustee to exercise his or her avoidance powers if transfers were made to a self settled trust or “equivalent” with the intent to hinder, delay, or defraud a creditor. A few planners have claimed that the Bankruptcy Code may put an end to planning with APTs. The basis of the concern is the ten year period where a transfer to an APT may be challenged if there is actual intent to prove a fraudulent conveyance.

While the new Bankruptcy Code may have some detrimental (as well as some beneficial affects on domestic APT planning), the key issue is whether a transfer was made *with the actual intent to hinder, delay, or defraud a creditor*. This must be proven before the issue of a ten year period even becomes relevant for discussion. The Bankruptcy Code does not make any change to proving whether a transfer to *any vehicle*, including an APT, is a fraudulent conveyance in the first place. Rather, the Bankruptcy Code adopts the standard Uniform Fraudulent Transfer Act (“UFTA”) definition. By adopting the UFTA, the case law interpretation of the UFTA should also apply.



b. Similar Device

It is uncertain how broad the term "similar device" will be construed.

i. Retirement Plans

Retirement plans are self-settled trusts. Therefore, it looks like all retirement plans should be subject to the ten year statute of limitations for a fraudulent conveyance.

ii. Beneficiary Defective Installment Sales

A newly marketed asset protection planning tool is the beneficiary defective installment sale to a discretionary trust that was created by the beneficiary's parents. Parents fund the trust with a nominal amount. Due to the beneficiary's powers of withdrawal, the trust is classified as a grantor trust under IRC § 678. The beneficiary then sells the beneficiary's interest in the beneficiary's FLP in exchange for an installment note. In essence, the beneficiary's assets are transferred to the trust based on the minority/marketability discount principles that are used in an installment sale to an intentionally defective grantor trust ("IDIT").


For tax purposes, there is no case, Revenue Ruling, or PLR directly on point sanctifying the IDIT installment sale transaction. Many think for tax purposes, the transaction is theoretically sound. Conversely, others express concerns under a "sham transaction" type of an analysis. "Sham transaction" is a tax term; it is not a creditor recovery term. However, if a judge wished to pierce the above arrangement, he or she could argue that the trust was "self-settled" and the family worked in harmony to transfer the debtor/beneficiary's assets through the installment sale. Another method to pierce the structure would be a dominion and control argument.

iii. FLPs and LLCs

In a very bad fact scenario, a transfer to an FLP or LLC might possibly come under the definition of "similar device." For example, if the FLP or LLC made disproportionate distributions to the client and commingled personal property, these factors may lead to the conclusion that the FLP was functioning more like a constructive trust for the benefit of the client.

	Alaska	Delaware	South Dakota	Nevada
Assert Exclusive Jurisdiction Over APTs :	Yes	Yes	Yes	No
Automatic Removal of Trustees	No	Yes	Yes	No
Other Issue:				
Protection of Advisors:	Yes	Yes	Yes	none

© Copyright 2006-2009 Merric Law Firm, LLC All Rights Reserved



4. Forcing the Litigation Into the DAPT State

a. Assert Exclusive Jurisdiction

Alaska, Delaware, and South Dakota all have provisions stating that their courts have exclusive jurisdiction over actions involving their DAPTs. It is uncertain whether other states will respect such a provision, and whether the U.S. Supreme Court will uphold such a provision. Yet, at a minimum this provision provides another hurdle that a creditor must surmount.

b. Automatic Removal of Trustees

Even if the action is not brought within the DAPT state's forum (i.e., the non-DAPT state does not respect the jurisdiction provision), Delaware, South Dakota, and Tennessee provide for the automatic removal of the trustee if a foreign court does not follow these states' DAPT laws. A successor trustee or new trustee under these DAPT statute will be appointed. Again, it is uncertain whether these provisions will survive challenge, but they still create a major statutory hurdle that a creditor must surmount.

5. Protection of Advisors

Alaska, Delaware, and South Dakota provide for the protection of an advisor or person who creates the APT.

Alaska – AS 34.40.010(e).

Delaware – 12 Del. Code § 3572(d) & (e).

South Dakota – So. Dak. § 55-16-13.

Flexibility You May Wish to Avoid

■ Co-Trustee???

- What about the Colorado Judge?
- Governing law of trust = Nevada
- This is a strong factor a judge may use to determine the conflict of law

■ Settlor Has Power to Veto Distributions

- This shows dominion and control over the trust

■ Settlor is Investment Advisor

- This also shows dominion and control

© Copyright 2006-2009

Merric Law Firm, LLC
All Rights Reserved



6. Flexibility You May Wish To Avoid

a. Co-Trustees

While many planners may like the idea of using an out of state co-trustee, a judge in such state may use such factor to hold that the out of state law should govern the trust – instead of the Domestic APT state.

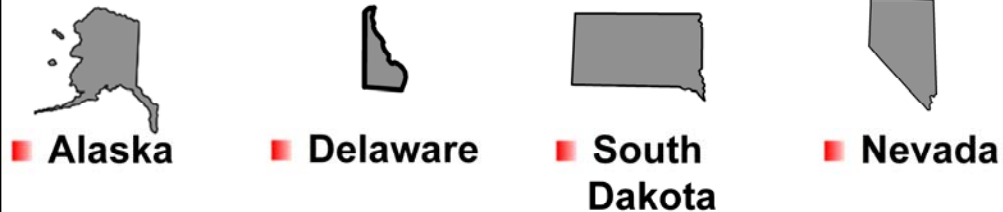
b. Veto Power

A settlor's veto power over distributions also may be a negative fact used by an out of state judge to hold the out of state law should govern the trust.

c. Investment Advisor

The same is true if the settlor serves as an investment advisor to the trust. An out of state judge may use such factor to hold that out of state law should control the trust.

Domestic APT Statutes That Attract Trust Business



Delaware Chancery??

© Copyright 2001-2009

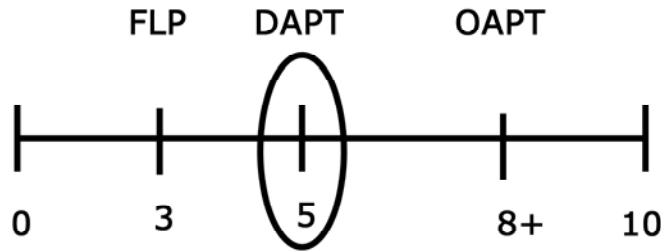
Merric Law Firm, LLC
All Rights Reserved



G. Domestic APT States That Attract Trust Business

There are many factors that go into the decision as to which state to select for clients that do not reside in a DAPT state. As can be seen from the tables, no one state emerges as the leader in all of the asset protection issues that have been discussed in the outline. Many advisors will have certain preferences of which asset protection elements are more important than others. Other advisors, will also consider the quality of the trustee services in various jurisdictions. Finally, all advisors, will take into account the client's individual needs when selection a DAPT state.

Effectiveness of a DAPT for Out of State Residents



© Copyright 2001-2009

Merric Law Firm, LLC
All Rights Reserved



H. Effectiveness

To date, there is still no case, not even a trial court case, stating whether and under what set of facts a Domestic APT will be effective for an out of state resident. In this respect, a DAPT needs to be compared to other asset protection tools. For example, a LLC or FLP in a state that does not provide that a charging order is the exclusive remedy might have a 3 on a scale of one to 10. Conversely, the offshore APT may be an 8+.

One thing is for certain, when in creditor negotiations, creditor's counsel are adamant that they can pierce the DAPT. The author would suggest that the creditor attorney's generally have little, if any, knowledge of trust law. However, this may not be the point. If a creditor's counsel is successful in convincing a client to pay them hourly to be the first case that reaches the U.S. Supreme Court, regardless of whether the creditor's counsel is successful, on that day, a nobody will instantly become a somebody.

Why Offshore APTs Are More Protective

1. **U.S. Judgments Not Recognized Abroad**

- *No Full Faith and Credit Clause Issues*
- *No Supremacy Clause Issues*

2. **Foreign APTs may provide greater protection in bankruptcy**

- *Under conflict of law principles, the statute of limitations of the foreign jurisdiction may apply*

3. **Foreign APTs need not be sole purpose asset protection vehicles**

- *Certain foreign investments cannot be sold on U.S. markets and require a foreign person to purchase*

© Copyright 2003-2009

Merric Law Firm, LLC
All Rights Reserved



I. Why Offshore APTs Are More Protective

1. US Judgments Won't Be Recognized

When one country fails to recognize judgments of another country, the plaintiff is forced to start the case over in the foreign jurisdiction. This means that there is no comity (i.e. Full Faith and Credit Clause) or Supremacy Clause issues that may be applied in the foreign jurisdiction. Most of the time, the plaintiff's legal counsel is not licensed abroad, is not familiar with a foreign legal system and has little incentive to abandon their practice to pursue extended offshore litigation. When contingent legal fees are not permitted, either the client or the attorney will need to pay counsel in the foreign country on an hourly basis to pursue the claim.

2. Foreign APTs May Provide Greater Protection in Bankruptcy

A foreign court is not subject to U.S. jurisdiction. Therefore, the 10 year federal statute would not apply in a foreign jurisdiction.

3. Foreign APTs Need Not Be Sole Purpose Asset Protection Vehicles

One of the primary complaints that a few planners have against domestic APTs is that their sole purpose is asset protection. Except in the state of Alaska, with the so called controversial "rainy day trust," it is true that asset protection is the sole purpose of most domestic APTs. Many asset protection planners will refute the sole purpose argument under the general principle that like tax planning, all clients are allowed to position their assets for asset protection purposes – so long as the transfer is not a fraudulent conveyance.

On the other hand, due to the SEC regulations, certain foreign assets may only be sold to foreign persons, which would include foreign trusts. Should a foreign trust purchase some of these foreign investments, there is a non asset protection purpose for the foreign trust.

Why Offshore APTs Are More Protective

4. ***Conflict of Law Principles May Dictate That a U.S. Court Should Follow Foreign Law***

- *Rothschild, Ruben, and Blattmachr*

5. ***Foreign Trusts Are Harder to Litigate Against***

- *Where to file*
- *How to file*
- *Employing D.C. and Offshore co-counsel*
- *Daunting Affect*

6. ***Foreign Jurisdictions Do Not Permit Contingent Legal Fees***

© Copyright 2003-2009

Merric Law Firm, LLC
All Rights Reserved



4. Conflict of Law Principles May Dictate That Foreign Law Will Apply

In the law review article, *Self-Settled Spendthrift Trusts: Should a Few Bad Apples Spoil the Bunch?*, 32 Vand. L. Rev. 763 (1999), Gideon Rothschild, Daniel Rubin, and Jonathan Blattmachr take a positive view that a U.S. judge will apply conflict of law principles and most likely apply the governing law as stated in the trust (assuming sufficient nexus to the governing jurisdiction) to determine creditor issues. If this is the case, most litigation will be favorably decided in favor of the offshore APT.

5. Foreign Trusts Harder to Litigate Against

Many attorneys will not even try to pursue judgments against offshore trusts. Not only are they not licensed to practice in the offshore jurisdiction, the entire legal process is not familiar to them. The mere existence of a foreign trust causes some cases to settle and others can be quickly resolved by offering some or all of the liability insurance company's policy, along with a release of any excess or personal liability, if applicable.

6. Foreign Jurisdictions Do Not Permit Contingent Legal Fees

This is quite important when personal injury or med mal cases are involved as the "pay day" comes at the end of the trial process. If the jurisdiction in which the trust is being administered does not permit contingent legal fees, the plaintiff must find a way to pay the foreign counsel if they wish to pursue the claim.

Why Offshore APTs Are More Protective

7. *Foreign Jurisdictions Frequently Require a Bond to Access Their Legal Systems*

- *Unlike U.S. Courts, many foreign courts do not appreciate frivolous lawsuits as well as frivolous motions on their shores.*

8. *Higher Burden of Proof*

9. *2 Year Fraudulent Conveyance Statute*

- *From the time of the transfer*
- *Not from when a creditor discovers the transfer*

© Copyright 2003-2009

Merric Law Firm, LLC
All Rights Reserved



7. Foreign Jurisdictions Frequently Require a Bond to Access their Legal System

Bonds are one way of making sure that the losing party will have something available from which to pay the prevailing party's legal fees. Just the posting of a bond is a deterrent that usually eliminates nuisance cases.

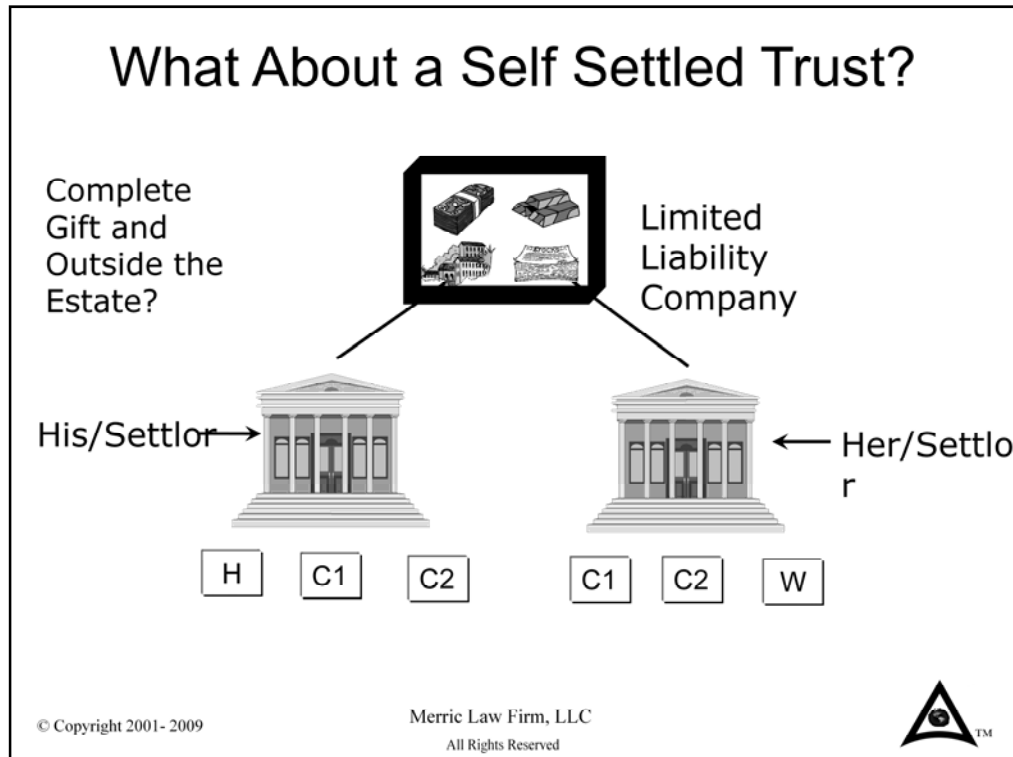
8. Burden of Proof Higher in Many Foreign Jurisdictions

The difference in the lower US civil standard of "preponderance of evidence" and the higher burden of proof with the US criminal standard of "beyond a reasonable doubt" is substantial. In foreign jurisdictions the burden of proof is the equivalent of the US criminal standard of "beyond a reasonable doubt" which makes it far more difficult for a potential creditor to prevail. In addition, many foreign jurisdictions place the burden of proving a transfer was a fraudulent conveyance on the creditor. Since it is difficult to prove any party's "intent", the creditors frequently fail in their attempts to prove their accusations when the foreign jurisdictions require that the party asserting the claim must prove the accusations.

9. Two Year Statute to Bring a Fraudulent Conveyance Action

Under the law of a few offshore jurisdictions, the creditor has two years to bring a fraudulent conveyance action from the time of the transfer. Unlike U.S. statutes, it does not matter when the creditor discovers the transfer to the APT, the creditor must bring the action within this two year period.

What About a Self Settled Trust?



J. Self Settled Estate Planning Trust

If one is able to draft around the doctrine of reciprocal trusts, husband and wife have access to the property gifted to both trusts. The amount that might be accessed depends upon the distribution standards as well as any savings clauses. Planning with trusts that have reciprocal beneficiaries generally requires both a husband and wife. Furthermore, to access trust assets, one must do so through the other spouse. Is there a possibility that a trust could be designed where a settlor could also be a beneficiary of a trust and the trust property might be excluded from the estate? This type of trust has been referred to as a self settled estate planning trust (i.e. “rainy day trustTM”ⁱ). A typical design for this type of trust has the following components.

- (1) The settlor as well as his spouse and descendants are named as beneficiaries.
- (2) An independent trustee is appointed within the meaning of IRC § 672(c).
- (3) The settlor may remove the independent trustee without cause and appoint another independent trustee within the meaning of IRC § 672(c).
- (4) The Trustee may make discretionary distributions (i.e., a common law discretionary trust) of any amount of income or corpus to any beneficiary – including the settlor.

ⁱ The term “Rainy Day Trust” is a service mark of Alaska Trust Company.

Estate Inclusion Issues

- IRC § 2036(a)(1)
 - Life Interest Rule
 - Implied Promise
 - Creditor Reach the Assets of the Trust

© Copyright 2001- 2009

Merric Law Firm, LLC
All Rights Reserved



1. Estate Inclusion Issues and the Estate Planning OctopusTMⁱ

The estate tax is broader than the gift tax. Just because the settlor completed a gift, possibly used all or part of his or her applicable exclusion, and even possibly paid some gift tax, does not mean the property is excluded from the settlor's estate. As noted, in the Modular Approach to Estate PlanningTM, one may view the estate tax similar to an octopus. The head of the octopus is IRC § 2033, which means that the client owns the asset. In order to get away from an octopus from devouring you, you must sever all eight arms. The eight arms are represented by IRC sections where generally the client does not own the property, but has retained some string of control over such property.

2. Three Tentacles to IRC § 2036

The biggest and most deadly arm of this estate planning octopus is IRC § 2036. It is the biggest arm of the octopus for estate tax inclusion, because the arm breaks down into three tentacles, and one of the three tentacles further breaks down into three more sub-tentacles. All of these tentacles and sub-tentacles bring trust property back into the estate using different rules. The three main tentacles are:

- (1) IRC § 2036(a)(1) – dealing with retained life interests;
- (2) IRC § 2036(a)(2) – which is generally concerned with the ability of a trustee to designate who receives what; and
- (3) IRC § 2036(b) – concerned with voting rights in closely held corporations.

ⁱ The “estate planning octopus” is trademarked by Mark Merric.

By case law, IRC § 2036(a)(2) and IRC § 2038 have an external standard (i.e. ascertainable standard) exception to their application.ⁱ The same is not true for IRC 2036(a)(1), there is no external or ascertainable standard exception. It is under IRC § 2036(a)(1) tentacle where three potential estate tax inclusion issues of a self-settled trust surface. IRC § 2036(a)(1)'s Three Sub-Tentacles are:

- (1) retained life interest;
- (2) implied promise;ⁱⁱ and
- (3) whether a creditor may reach the assets of a trust in satisfaction of a legal obligation.ⁱⁱⁱ

ⁱ *Estate of McTighe*, TC Memo 1977-410, *Jennings v. Smith*, 161 F.2d 74 (2nd Cir. 1947); *Estate of Pardee*, 49 TC 140 (1967); PLR 9347014.

ⁱⁱ Treas. Reg. § 20.2036-1(a)(1).

ⁱⁱⁱ Treas. Reg. § 20.2036-1(b)(2).

Classification of Distribution Interests

- Mandatory Interest

- Support Interest

- Discretionary Interest

© Copyright 2001- 2009

Merric Law Firm, LLC
All Rights Reserved



3. IRC § 2036(a)(1) – Life Interest Rule

In order to determine whether there is an estate inclusion issue under IRC § 2036(a)(1) for an APT, one must look to the common law classification of trusts to determine whether a beneficiary holds an enforceable right to a distribution. Generally, in determining whether a beneficiary had an enforceable right to a distribution, there are primarily three classifications of trusts: (1) mandatory interestⁱ; (2) support interest; and (3) a discretionary interest.

a. Mandatory Distribution Interest

Usually, a mandatory distribution standard requires that a fixed amount, percentage, or definition of income be paid out annually. For tax purposes, a QTIP, which requires all income to be paid to the surviving spouse, is a mandatory distribution. The same for the annuity or uni-trust interest in a GRAT or CRUT. Similarly, a \$100,000 distribution to a certain beneficiary that is required to be made each year is a mandatory distribution. If the settlor holds a mandatory distribution interest, there is an estate inclusion issue under IRC § 2036(a)(1).ⁱⁱ

ⁱ For creditor purposes, the Restatement Second provided spendthrift protection to both mandatory and support trusts, and therefore does not make a distinction between these two types of trust. The Restatement Third and the Uniform Trust Code do not provide protection for a mandatory distribution that has become overdue, thereby reducing the asset protection under common law and creating a third classification for creditor purposes.

ⁱⁱ *Estate of Uhl*, 241 F.2d 867 (7th Cir. 1957) as to the \$100 mandatory income distribution that resulted in estate inclusion of the corpus necessary to produce the \$100 payment.

b. Support Distribution Interest

Under common law, the term support trust means that the distribution creates an enforceable right in a beneficiary based on a standard. Generally, a support trust is created with mandatory words such as “shall” or “must” combined with a standard that is capable of judicial interpretation. For example, Courts have determined the following language to create a support trust:

- “[T]he trustee shall pay...[to the settlor’s] daughters such reasonable sums as shall be needed for their care, support, maintenance, and education” [emphasis added] was determined to be a support trust.ⁱ
- “[T]he Trustee shall use a sufficient amount of the income to provide for the grandchild’s support, maintenance and education” [emphasis added] was held to be a support trust.ⁱⁱ

If the settlor/beneficiary has an enforceable right to a distribution, again there is an estate inclusion issue.ⁱⁱⁱ

c. Discretionary Interest

It is only if a settlor hold a discretionary interest where he or she holds neither an enforceable right to a distribution nor a property interest that there is not an estate inclusion issue under the IRC § 2036(a)(2) tentacle.^{iv} For purposes of this article, the term common law discretionary trust refers to a trust where a beneficiary has neither an enforceable right to compel a distribution nor a property interest, and no creditor may attach such interest. At this point the author needs to clarify an area of confusion among some practitioners. Under common law, the term “purely discretionary trust” or “wholly discretionary trust” under common law did not require that the distribution interest not have any standards. Rather, in the hundreds of cases on point, almost all common law discretionary trusts contained a standard for making distributions. However, as discussed in detail in my upcoming LISI Series on Spousal Access Trusts, the Restatement Third rewrites the definition of a common law discretionary trust creating an enforceable right in almost all discretionary trusts. The good news, it does not appear that the courts are adopting the Restatement Third in this area of law.

ⁱ *In re Carlson’s Trust*, 152 N.W.2d 434 (SD 1967).

ⁱⁱ *McElrath v. Citizens and Southern Nat. Bank*, 189 S.E.2d 49 (GA. 1972).

ⁱⁱⁱ *Estate of Boardman v. Comm’r*, 20 T.C. 871 (1953); *Estate of John J. Toeller*, 165 F.2d 665 (7th Cir. 1946); and *Blunt v. Kelly*, 131 F.2d 632 (3rd Cir. 1941). For creditor purposes when a beneficiary has an enforceable right to a distribution, it is referred to as a “support trust.”

^{iv} *Estate of Uhl*, 241 F2d 867 (7th Cir. 1957), as to the principal that was wholly in the discretion of the trustee “the settlor reserved no right to compel the trustee to pay him any sums” Both the *Estate of German*, 7 Cl. Ct. 641 (1985) and *Estate of Wells*, 475 F2d 1142 (Ct. of Claims 1964) are self settled discretionary trust cases where the court held in favor of the taxpayer, and it appears the Service did not attempt to argue that there was an enforceable right in a discretionary trust.

The bad news is that there is nothing other than a state a statute codifying the Restatement Second that will prevent a judge from doing so. Therefore, unless the trust is to be sited in a jurisdiction that has addressed this enforceable right issueⁱ, I would suggest the following distribution language:

My Trustee may distribute as much of the net income and principal as my Trustee, in its sole, absolute, and unfettered discretion, determine to any beneficiary listed in Section 1.07. My Trustee, in its sole, absolute, and unfettered discretion, at any time or times, may exclude any of the beneficiaries or may make unequal distributions among them. Also, my Trustee, in its sole discretion may distribute all of the income and principal of this Trust to one of the beneficiaries and exclude all other beneficiaries from any of the Trust Property. When making distributions, my Trustee may, in its sole, absolute, and unfettered discretion may, but need not, consider a beneficiary's income or other resources that are available to the beneficiary outside of the trust and are known to the Trustee. The power to make a distribution in my Trustee's sole, absolute, and unfettered discretion includes the power to withhold making a distribution to any beneficiary in my Trustee's sole, absolute, and unfettered discretion.

In keeping with the wholly discretionary nature of this trust and all separate trusts created hereunder, no beneficiary, except as regards to any irrevocable vesting in the beneficiary's favor, shall have any ascertainable, proportionate, actuarial or otherwise fixed or definable right to or interest in all or any portion of any trust or its property. It is my intent that the trustee have all of the discretion of a natural person, and that a distribution beneficiary holds nothing more than a mere expectancy. It is also my intention that the above language be interpreted as to provide my Trustee with the greatest discretion allowed under law.

Distributions made to a beneficiary under this Article shall not be considered advances and shall not be charged against the share of such beneficiary that may be distributable under other provisions of this agreement. Any undistributed net income shall be accumulated and added to the principal of the trust.”

The author is hopeful that the above language would create neither an enforceable right to a distribution nor a property right under even a Restatement Third analysis. This being the case, the first estate planning sub tentacle of IRC § 2036(a)(1) does not create an estate inclusion issue.

Analogy to a Constitutional Trust

- **Continuous distributions for living expenses**
- **Substantial distribution to settlor**
 - Partnership assets needed to pay the estate tax
- **Transferred almost all of net worth to the P/S**



© Copyright 2003-2009

Merric Law Firm, LLC
All Rights Reserved



4. Analogy to the Constitutional Trust

Prior to the Service's first successes in attacking some FLPs under IRC § 2036, much of the case law for recovery dealt with a tax scam commonly known as the Constitutional, pure, equity, apocalypse, or contract trust ("Constitutional trust"). With these trusts, the settlor was also a beneficiary of the trust (i.e. self-settled trust). Under this type of trust, promoters claimed that neither the settler (nor the trust) paid any income tax, because the settler did not control anything. There was no gift tax, because the settler was transferring property in exchange for beneficial shares. Finally, there was no estate tax, because the settlor, who was also a beneficiary of the trust, held nothing more than a mere expectancy of a distribution. The income tax benefits of these trusts were false due to the grantor trust rules, as well as assignment of income cases. The gift tax benefits were also false. Conversely, under common law, a discretionary interest in trust is not a property interest and a beneficiary does not have an enforceable right to a distribution. Therefore, unless there is some other estate tax inclusion rule, the Constitutional trust would escape estate taxation. As one method to force inclusion of the Constitutional trust into the decedent's estate, the Service had three lines of cases based on an oral promise between the settlor and the trustee that the trustee would make a distribution to the settlor/beneficiary whenever he or she requested a distribution.

a. Continuous Distributions For Personal Expenses

The first line of cases attacking the Constitutional Trust was that after formation, continuous distributions were made only to the settlor as a beneficiary to meet their personal expenditures. When there are multiple beneficiaries of a trust, a trustee will normally not make distributions only to the settlor/beneficiary. Therefore, these cases held that there must have been an oral promise with the trustee to make continuous distributions whenever the settlor requested. *Estate of Skinner*, 197 F. Supp. 726 (3rd Cir. 1963); *Estate of Marguerite Green*, 64 TC 1049 (1971); but See *Estate of Wells*, TC Memo 1981-574 where all income was paid to the settlor, but she used such distributions only for travel – not ordinary and necessary expenses.

As a bad fact, supporting estate inclusion under IRC § 2036(a)(1), many of the FLP cases cite continuous distributions made from the partnership to pay the personal expenses of mom or dad. To make matters worse, generally, these distributions were also disproportionate distributions discussed in the failing to respect the separateness of the partnership.

b. Substantial Distribution to the Settlor

Again, analogizing to the Constitutional trust, when there are multiple beneficiaries and the trustee makes a large distribution only to the settlor/beneficiary, there seems to be an implied promise to make a distribution whenever the settlor would make a request. *Estate of McCabe*, 475 F2d 1142 (Ct. of Claims 1964). This point is more subtle when looking at family limited partnerships. In most of the bad fact FLP cases, the client died within a couple of years after creating the FLP. Further, almost all of the client's assets were transferred to the FLP. Therefore, even with the minority discounts, the client would owe a substantial estate tax. However, at time of the death, the client's estate lacked the assets to pay the estate tax – unless there was a substantial distribution from the partnership. Again, the Constitutional analogy factor appears to be being applied to FLPs, because after the death of the client, the partnership must make a substantial distribution to pay the decedent/client's estate tax.

c. Transfer Almost All the Client's Net Worth

In *Strangi*, a client transferred 98% of his net worth to the FLP. In *Estate of Paxton*, 86 TC 785 (1986) the Tax Court found an implied promise when a client transferred virtually all of his net worth to a Constitutional trust. The Tax Court held that no one would leave himself or herself penniless during the later years of his or her life and would need his or her assets the most. Therefore, when Paxton transferred most of his assets to a Constitutional Trust, there had to be an implied promise that the Trustee would return the assets to Paxton as a discretionary beneficiary of the trust if he ever needed the assets. This is the same bad fact that is frequently cited in the FLP cases.

Creditor Can Reach the Assets of the Trust

- Offshore APTs
 - PLR
- Domestic APTs
 - Out of state settlor
 - Exception creditors

© Copyright 2008- 2009

Merric Law Firm, LLC
All Rights Reserved



5. Offshore APTs

There has been one favorable ruling that held transfers to a self settled trust were both a completed gift and excluded from the taxpayer's estate. PLR 9326006. Unlike Domestic APTs, offshore APTs do not have Constitutional issues such as the full faith credit clause of the U.S. constitution or the Supremacy clause. Further, almost all offshore APT jurisdictions do not have exception creditors. In this respect, it may be possible to create an offshore APT where the creditors cannot reach the settlor/beneficiary's interest.

6. Domestic APTs

In 1998, a similar PLR was requested regarding an Alaska APT. PLR 9837007. In this case, the Service held that transfers to the trust would be a completed gift, but refused to rule on whether the assets would be included in the estate. In 1999, a PLR was requested on a Delaware APT. This time, the Service refused to rule on both whether the transfers to the APT were a completed gift and whether the assets were included in the settlor's estate. When refusing to rule on the issue the Service may have been uncertain regarding implied promise issues that would only be known with hind sight analysis after the settlor passed away. On the other hand, the Service may have had some concerns regarding whether a creditor could reach the assets of the trust, which would also result an estate inclusion issue.

There are primarily two concerns with domestic APTs:

- (1) Do Domestic APT statutes protect an out-of-state resident's beneficial interest;
- (2) Even for in-state residents, will an exception creditor cause an estate inclusion issue.

Non-Resident Estate Inclusion Issues

- No case law
- Conflict of Laws –
 - Full Faith & Credit
 - Hanson v. Denckla
- Supremacy Clause



© Copyright 2001-2009

Merric Law Firm, LLC
All Rights Reserved



a. Non-Resident Estate Inclusion Issues

At present, these statutes are untested, and thus there has been considerable debate among the different promoters of onshore v. offshore trusts as to whether these trusts do in fact work. Naturally the onshore promoters say they do, and the offshore promoters say they don't. The offshore promoters have two main arguments regarding Constitutional issues that surround these trusts:

- a. Full Faith and Credit Clause; and
- b. Supremacy Clause.

The Constitutional asset protection issues regarding these two Clauses were previously discussed in this outline.

Exception Creditors & IRC § 2041

- Difference between
 - A power of appointment IRC § 2041 and
 - Reserved right under IRC § 2036
- Distribution interest
 - Cannot initiate the action
 - Fiduciary duties of a trustee

© Copyright 2008- 2009

Merric Law Firm, LLC
All Rights Reserved



b. Exception Creditors & IRC § 2041

Some commentators have expressed concern that the exception creditors provided in many DAPT statutes may result in an estate tax inclusion issue, because these exception creditors may reach the assets of a DAPT. Comparing third party trusts to a self-settled trust, over about ½ of the states provide for a child support exception creditor. To a lesser extent, alimony is an exception creditor. Finally, to a much lesser extent, governmental claims, necessary expenses of a beneficiary, and attorney fees are exception creditors in some states. Finally, in one state, Georgia a tort creditor is an exception creditor to a support trust. (This is why many, if not most, estate planners draft common law discretionary trusts in Georgia to avoid this issue).

i. Is There a Difference Between IRC § 2041 and § 2036

One might note that there appears to be no case, revenue ruling, or PLR on point where the presence of a state exception creditor created an estate inclusion issue for a beneficiary of a third party trust under IRC § 2041. Therefore, one might conclude that there may not be an issue under IRC § 2036. The following analysis will support the author's disagreement with such a statement.

First, § 2041 does not apply to a power reserved by the settlor of a trust, rather it applies to a donee who receives a power. Treas. Reg. § 20.2041-1(b)(2). IRC §§ 2036-2038 apply to reserved powers of a settlor. While IRC §§ 2036-2038 have many substantially similar estate inclusion principals with IRC § 2041, the code sections are not identical. In order to point out a most likely determinative issue between these code sections, the analysis will begin with IRC § 2041 and exception creditors.

ii. Is a Distribution Interest, By Itself, a Power of Appointment

Treas. Reg. § 20.2041-1(c)(1) states, “A power of appointment exercisable for the purpose of discharging a legal obligation of the decedent or for his pecuniary benefit is considered a power of appointment exercisable in favor of the decedent or his creditors.” A power exercisable in favor of one’s creditors is a general power of appointment, and an ascertainable standard will not cure the estate inclusion issue of a legal obligation.

If a beneficiary’s distribution interest is classified as a power of appointment and there is no other theory, such as an “act of independent significance,” then all third party trusts in states that provide for exception creditors would have estate inclusion issues. Since there appears to be no case, revenue ruling, or PLR with this holding, it appears that either a distribution interest, by itself, is not a power of appointment or an exception creditor is an act of independent significance.

Treas. Reg. § 20.2041-1(b) does not provide a precise definition of a power of appointment. Rather, it holds:

(1) *In general.* --The term "power of appointment" includes all powers which are in substance and effect powers of appointment regardless of the nomenclature used in creating the power and regardless of local property law connotations. For example, if a trust instrument provides that the beneficiary may appropriate or consume the principal of the trust, the power to consume or appropriate is a power of appointment.

In order to discuss what constitutes a power of appointment, the author will provide a brief discussion of the following various beneficial interests in trust. For these examples assume that the trustee is an independent trustee within the meaning of IRC § 672(c).

- (1) Crummey withdrawal power – With this power, the holder alone, almost always without any restrictions such as a limitation for HEMS, may withdraw from \$5,000 to the annual exclusion amount annually during a specified period of time. Since the holder may unilaterally withdraw the amount, it is a power, it is also a general power of appointment.
- (2) Withdrawal right of the corpus. Some trusts are drafted so that a beneficiary as an unconditional withdrawal right of 1/3 of the principal at a specified age, let’s say age 25, ½ of the principal at age 30, and the balance of the principal at age 35. This is also a power that may be unilaterally executed by the beneficiary and is a power of appointment.
- (3) Instead of giving the beneficiary a withdrawal right, the trustee is required to distribute 1/3 of the assets at age 25; ½ of the assets at age 30; and the balance at age 35. Here, the beneficiary does not have a unilateral power to withdraw the assets. Rather, the beneficiary must sue the trustee should the trustee not distribute the trust assets pursuant to the terms of the trust.

One might wonder whether (3) is a power of appointment. In (1) and (2), the beneficiary unilaterally had the power to demand the distribution, not subject to any fiduciary powers. In (3), the beneficiary may also make a demand that the distribution is due, however should the trustee not follow the terms of the trust, the beneficiary may also have to sue the trustee to force a distribution. Conversely, the same is true for (1) and (2), a beneficiary may have to sue a trustee to follow the terms of a trust regarding a power of appointment. Based on the above, some planners might classify (3) as a power of appointment, and others might conclude it is a distribution interest.

The analysis becomes more convoluted when one attempts to distinguish between current distribution interests.

- (4) If a beneficiary has a mandatory right to a quarterly distribution of income, is this a power of appointment? Similar to the discussion in (3) above, once the quarter has passed and there is no distribution, the beneficiary may sue the trustee for a distribution. In the event that (3) is classified as a power of appointment, the same result seems to apply with a mandatory interest.
- (5) With a support interest, upon the beneficiary making a request for a distribution, the beneficiary has an enforceable right to a distribution pursuant to the standard. Is this interest classified as a power of appointment?
- (6) With a common law discretionary interest, a beneficiary has neither an enforceable right to a distribution, nor a property interest. Therefore, these interests are not classified as either a “power” or a “right.”

Regarding (6), there appears to be considerable authority that a common law discretionary interest is not a power of appointment. Rev. Rul. 76-378 states:

“While the decedent had the power to invoke a process of judicial review had the trustee, in the judgment of the decedent, failed to liberally exercise its discretionary power of invasion on the decedent’s behalf, this kind of power does not transfer a power of invasion granted an independent trustee to the beneficiary of the trust.”

Rev. Rul. 76-378 cites *Estate of Mary Joyce Cox*, 59 T.C. 825 (1973) and *Security-Peoples Trust Co.*, 238 F.Supp 40 (W.D. Pa. 1965). In *Estate of Cox*, the Tax Court held that the trustee, not the beneficiary, had the power of invasion. In other words, the Tax Court did not even get to the analysis of whether there was a general power of appointment, because the beneficiary of a discretionary interest did not have a power. The power to make distributions was in the trustee. The court further held, “To decide that the beneficiary had an implied power of invasion would be inconsistent with such arrangement and with the provision expressly granting the trustee sole and exclusive management powers.” When interpreting the “management powers,” the Tax Court concluded that “it seems clear that the petitioner’s power of management was intended to include the power of determining when Mrs. Cox’s income was insufficient and when the corpus should be invaded.” Conversely, the District Court in *Security-Peoples Trust Co.* held that the beneficial interest was not a general power of appointment. At the same time, it seemed to imply that the beneficial interest alone was not a power of appointment when the court held, the trustee had the discretion alone to invade income or principal for the beneficiaries, with regard to protection of interests of future and remainder beneficiaries. Some further analogous authority that a distribution interest is not a power of appointment is also provided by Rev. Rul. 82-63 that when reviewing whether a power of appointment exists, when the power is vested in a trustee, not the beneficiary, there is not a power of appointment.

Except for Rev. Rul. 82-63, all of the cites immediately above deal with a discretionary interest combined with an independent trustee. Therefore, one might narrowly conclude that the above authority may not apply to a support interest. Rev. Rul. 82-63 makes another possible distinguishing point between a distribution interest and a power of invasion. The ruling states, “a power of invasion is different than a power of distribution.” In this revenue ruling, the Service noted that in *Dana v. Gring*, 371 N.E.2d 755 (Mass. 1977), the decedent was to receive income for life and as much of the principal as the trustees deemed necessary for the reasonable welfare or happiness. Unlike the Revenue Ruling 76-368 and cases cited on the previous page, the decedent/beneficiary was one of three trustees. Generally, this would result in an automatic estate inclusion issue, because in her power as one of the three co-trustees, the beneficiary could make discretionary distributions to herself. Therefore, her powers as a co-trustee would create a power of invasion when coupled with her beneficial interests. However, with quite a few contortions, the Massachusetts Supreme Court concluded that based on the circumstances “happiness” was an ascertainable standard. Part of this reason was that as a co-trustee with fiduciary duties could not have distributed trust principal to a life beneficiary solely on the basis of her subjective desires. “In the absence of instructions to the contrary (a trustee is bound) to administer his trust with an eye to the remainder interest as well as to the interest of a life beneficiary.” The court also noted that as a general rule, a trustee beneficiary may not participate in decisions regarding distributions of principal to himself.

While many authorities will have different opinions regarding the Massachusetts holding that in certain circumstances “happiness” is an ascertainable standard, this is not the critical point of discussion under Rev. Rul. 82-63. The Service published the revenue ruling to advise all taxpayers that it would not be following a different factually distinguished case - *Brantingham v. U.S.*, 631 F.2d 542 (7th Cir. 1980). In *Brantingham*, the decedent had a power in a non-fiduciary capacity to invade the corpus for the beneficiary’s maintenance, comfort, and happiness.” The Revenue Ruling notes that, “The discretionary power in *Gring* was a fiduciary power of distribution and was, therefore, limited by the fiduciaries’ obligation to preserve the corpus for all beneficiaries. The court noted that the trustees had to administer the trust with “an eye to the remainder interest. The power in *Brantingham* was a power of invasion, exercisable by the decedent in an individual capacity and, therefore, was not limited by any fiduciary considerations regarding preservation of the corpus for other beneficiaries. . . .”

The analysis in Rev. Rul. 82-63 brings forward a very important distinction. A power held in an individual capacity, unless otherwise stated in the trust document, may be exercised in a non-fiduciary capacity. There is no requirement to look at any other interests that a different beneficiary may hold, before the beneficiary demands a distribution. Conversely, if a beneficiary is serving as a trustee, he or she has fiduciary obligations, before making any distribution to himself or herself. These fiduciary obligations still do not prevent an estate inclusion issue if the beneficiary’s distribution interest is not limited to an ascertainable standard. However, Rev. Rul. 82-63 may be interpreted that a distribution interest alone is not a power of appointment. If a distribution interest is not a power of appointment, an exception creditor does not create an estate inclusion issue for a third party trust.

On the other hand, in the event a support distribution interest is a power of appointment, then another issue would need to be examined, is an exception creditor an act of independent significance. Otherwise, consider the following situation. The trust instrument states, “the trustee shall make distributions for health, education, maintenance, and support.” The trust is sited in Georgia. Spouse and children are named as beneficiaries. Spouse is not a trustee, and she passes away. She had an enforceable right to a distribution that was based on an ascertainable standard. So at first, it does not appear that she has a general power of appointment. Yet, under Georgia law, any tort creditor may reach the assets of a support trust. GA CODE Ann. § 53-12-28(c)(1). Therefore, if a support distribution interest is classified as a power of appointment, a tort creditor may reach the support distribution interest, which would result in estate inclusion issue under § 2041.

iii. Difference Between IRC § 2036 and IRC § 2041

IRC § 2041 regarding estate inclusion issues for donees requires that the decedent hold a power of appointment. Conversely, IRC § 2036 does not require the settlor/decedent to hold a power of appointment. Rather, IRC § 2036 requires that the settlor hold a mere enforceable right to income or principal. *Estate of Boardman v. Comm’r*, 20 T.C. 871 (1953); *Estate of John J. Toeller*, 165 F.2d 665 (7th Cir. 1946); and *Blunt v. Kelly*, 131 F.2d 632 (3rd Cir. 1941).

Exception Creditors & DAPTs

- Reserved right under IRC § 2036
 - Enforceable right = Estate Inclusion
 - Creditor can reach the beneficial interest = Estate Inclusion
- Acts of Independent Significance
 - Not directly on point
 - Except, possibly breaking a law

© Copyright 2008- 2009

Merric Law Firm, LLC
All Rights Reserved



c. Exception Creditors & Domestic APTs

As previously noted, a settlor's interest in a self settled trust should be drafted so that the settlor/beneficiary does not have an enforceable right to a distribution. However, unlike offshore APTs that address the asset protection from the English discretionary nature of the beneficiary's interest, domestic APTs relied on American spendthrift protection. When doing so, almost all domestic APTs created exceptions to the spendthrift provision, allowing these exception creditors to reach a settlor/beneficiary's interest in these trusts. If an exception creditor can reach a beneficiary's interest, does this create an estate inclusion issue under IRC § 2036?

Treas. Reg. § 20.2036-1(b) states –

(2) The "use, possession, right to the income, or other enjoyment of the transferred property" is considered as having been retained by or reserved to the decedent to the extent that the use, possession, right to the income, or other enjoyment **is to be applied toward the discharge of a legal obligation of the decedent**, or otherwise for his pecuniary benefit. The term "legal obligation" includes a legal obligation to support a dependent during the decedent's lifetime." {emphasis added}.

At first glance, it appears that all domestic APTs that provide for any exception creditor would be included in the settlor's estate. However, some authors have taken the position that certain exception creditors are "acts of independent significance." In the event an action is classified as an "act of independent significance," then there is not an estate tax inclusion issue. For example, a trust provides that the beneficiaries are the settlor's children. After the creation of the trust, the settlor and his spouse give birth to another child. By the terms of the trust, the newborn child is automatically added as a beneficiary. Unless child birth (and adoption) are acts of independent significance, the act of giving child birth would change the beneficial interests of the trust under IRC § 2036(a)(2) and IRC § 2038(a)(1). Furthermore, even if the settlor did not have a child, immediately prior to death, there would be the astronomical chance that the settlor or the settlor's spouse could have or adopt a child. Therefore, Rev. Rul. 80-255 held that a trust beneficiary that is added by giving birth or adoption is an act of independent significance, and therefore there is no estate inclusion issue.

Related to a child support exception creditor, the author questions whether Rev. Rul. 80-255 is on point. Not paying child support is simply not paying a legal support obligation. It seems to be quite a bit of a stretch, to analogize the birth or adoption of a child to not paying child support years later, presumably after a divorce.

Another act of independent significance is a settlor changing a beneficial interest through the act of divorce. In *Estate of Tully*, 528 F.2d 401 (Ct. Cl. 1976), decedent had entered into an employment contract whereby the employer promised to pay death benefits to his widow. The Court of Claims held that the decedent did not have the power to revoke within the meaning of IRC § 2038, even though the decedent could have divorced the spouse, thereby eliminating the spouse's possible status as widow. The Court held, "In reality, a man might divorce his wife, but to assume that he would go through an entire divorce process merely to alter employee death benefits approaches the absurd." A similar result was reached in PLR 8819001, where the trust contained a provision that stated, "In the event decedent and his wife become divorced, his wife shall have no further rights therein, and no further payments shall be paid to her." The PLR went on to cite *Estate of Tully*, "the act of divorcing one's spouse is an act of independent significance, the incidental and collateral consequences of which is to terminate the spouse's interest in the trust.

The above acts of independent significance directly deal with a spouse's beneficial interest in an employment contract or a trust being terminated upon a divorce. The Court of Claims Court in *Tully* noted that the settlor would have the power to terminate the interest by filing a divorce, however, to do so solely for the purpose of altering beneficial interests would be absurd. The author would agree that divorcing one spouse to alter the beneficial interests in almost all cases would be absurd. However, this is not why people divorce. Generally, they no longer get along. The act of not paying child support or alimony may well be due to financial hardship after a divorce or possibly an anger issue. In this respect, the author questions whether there is a direct analogy regarding how the above authority supports an act of independent significance for child support.

Conversely there may be an indirect analogy. Behind the Court's statement that divorcing one's spouse to alter benefits (or beneficial interests) "approaches the absurd," deals with the probability that such action would ever occur. Personally, the author has been involved in the creation of offshore and domestic APTs for over 15 years, and has never seen or heard from any other planner that an APT was used to shirk a child support obligation. The author finds it almost astronomically remote that a person who can afford to settle an APT, would sit in jail, in order to shirk a child support order. Therefore, as to child support there may be an indirect analogy applicable to an act of independent significance based on the remoteness of the occurrence of the event.

The issue of remoteness was also discussed in *Ellis v. Comm'r*, 51 T.C. 182 (1968). In *Ellis*, as part of a prenuptial agreement, the taxpayer created a trust for his spouse. The trust provided that the trustee "shall pay to or apply for the benefit of the donor's wife, Viola ELLI, such amounts as the trustee from time to time, in its discretion, deems advisable for her care, comfort, or support and shall add to principal any income not so distributed." Husband reduced the amount of the reported gift to the trust based on the income interest that his wife was to receive. Husband argued that with regard to the gift of the life estate, he retained sufficient control over the disposition of income, as to make the gift of the life estate incomplete. The trustee was a bank. Husband could not appoint himself as trustee. Rather, husband argued that under Arizona law, the trustee needed to look to the husband's obligation to support his wife before making a distribution. Therefore, the husband could refuse to provide any support for his wife (i.e. throw her out of the house and refuse to pay for any expenses while he was happily married), and this would force the trustee to make distributions for her support.

The Tax Court did not accept petitioner's reasoning. Rather, it noted that "in theory, this [argument] may appear to be control, but as a practical matter it would be extremely difficult for petitioner to exercise this power. For petitioner to cause a situation to occur which would compel the trustee to distribute the trust's income to Viola, petitioner would have to create a major domestic crisis. Thus, due to the undesirable consequences which would result, we believe it is extremely unlikely that the petitioner would or could cut Viola off at any time he so desired."

The above fact pattern does not seem to be on point with a divorced person not paying alimony. In *Ellis*, the taxpayer is not divorced or even contemplating divorce. If he arbitrarily ceases supporting his spouse, the court is implying that he most likely would end up in a divorce. Therefore, the court finds the likelihood of the taxpayer purposefully refusing to support the spouse he currently is married to as quite remote. In contrast the fact pattern regarding non-payment of alimony seems quite different. With alimony, a divorce has occurred. Sometimes, there is quite a bit of hostility between the parties, and one party simply stops paying. Unlike child support, someone who does not pay alimony usually does not end up being incarcerated. Furthermore, where the author has never met a potential client that sought to shirk a child support obligation by the creation of an APT, the same is not true with alimony. The author has had potential clients and has heard from other advisors of clients seeking to create a domestic APT to shirk an alimony claim. To date, the author has turned down these type of engagements. In this respect, if "remoteness" is the pivotal test to whether a certain act constitutes an act of independent significance, it appears an alimony exception creditor creates a greater estate inclusion issue than a child support exception creditor.

On the other hand, there was another holding in *Ellis* that may prove to be more fruitful. The court went on further to note that Arizona law required a husband to support his wife during coverture, by statute. The court then concluded, “Under these circumstances, petitioner should not be considered to have any control where to exercise the power it would be necessary to do any unlawful act.” A narrow reading of the holding would be that it only applies to a spouse’s duty to support the other spouse while he or she is married. A broad reading of the holding would support the conclusion that any act that would require the breaking of a law is an act of independent significance. At present, “breaking the law” is undefined. However, the author would guess that it means breaking a criminal statute. In this respect, a child support exception creditor, and in some states possibly an alimony exception creditor could be an act of independent significance.

Not paying child support might be classified as an act of independent significance under either a remoteness theory or a breaking the law theory. Alimony might possibly be classified as an act of independent significance in some states under a breaking the law theory. However, what about other possible state exception creditors?

In addition to child support and alimony, the Restatement (Second) and (Third) of trusts lists the following exception creditors.

1. governmental claims;
2. attorney fees;
3. necessary expenses of a beneficiary.

Depending on whether the governmental claim is based on a criminal claim, it may be considered breaking the law. Conversely, non-payment of attorneys who represent a beneficiary and non-payment of hospital or other necessary expenses of a beneficiary would not be breaking a law. Obviously, a tort creditor exception would not be an act of independent significance.

Exception Creditor By State

- Alaska & Nevada – no exception creditors
- Wyoming – child support only
- Tennessee – child support & alimony
- Delaware, South Dakota, New Hampshire, & Rhode Island
 - Child support & Alimony – SD ?
 - Preexisting tort creditor

© Copyright 2008- 2009

Merric Law Firm, LLC
All Rights Reserved



c. Exception Creditors & Domestic APTs

The conservative approach to avoiding estate inclusion issues would be to use either Alaska or Nevada, because these jurisdictions have no exception creditors. Conversely, there will be those planners that take the position that only child support is an act of independent significance, and therefore Wyoming may be a safe jurisdiction to create a self settled estate planning trust. Then there will be those such as Richard Nenko that take the position that both child support and alimony should be classified as an act of independent significance.

In addition to the child support and alimony issue, Delaware, South Dakota, and New Hampshire allow a tort creditor that existed at the time of the creation (or funding as the case may be) of the trust to be an exception creditor. Some planners might view this tort creditor as an exception creditor. However, there are a few qualifications that need to be made. First, the tort must have been committed at the time the transfer was made to the trust. If the settlor did not have a present tort creditor at the time of funding, there is no exception creditor created by this provision. Second, even if the settlor had a present tort creditor, the effect of the statute appears to extend the period of time the tort creditor may recover to the statute of limitations for the tort. In this respect, this tort creditor exception appears to be functioning more like a fraudulent conveyance issue with possibly a longer statute of limitations. Anyway, how the Service will view this preexisting tort creditor issue is unknown, and for the conservative planner it may be better to avoid the issue by going to a different jurisdiction.

Exception Creditor By State

- Missouri –
 - child support & alimony
 - attorney fees
 - and governmental claims to the extent provided by statute

- Utah
 - child support
 - receives benefits – Medical Benefits recovery act
 - State claims or state tax

© Copyright 2008- 2009

Merric Law Firm, LLC
All Rights Reserved



In addition to child support and alimony, Missouri's exception creditors include attorney fees, and governmental claims to the extent provided by statute. Utah's exception creditors include child support, the state to the exception a settlor receives any benefits under the Medical Benefits Recovery Act, and any state claim. The author is not aware of any other author's position or possible authority that would consider attorney fees or governmental claims to be an act of independent significance. For this reason, the author would suggest avoiding these states when created a self-settled estate planning trust.

Federal Exception Creditor

- **Property interest under federal law**
 - CCA 200614006
 - Levy and attachment
 - Enforceable right = property interest
 - If an exception creditor can attach, so can the federal government
- UTC & DAPT Exception Creditors
- May wish to use only Alaska or Nevada for a self-settled asset protection trust

© Copyright 2008- 2009

Merric Law Firm, LLC
All Rights Reserved



d. Federal Claims

i. Property Interest

The Internal Revenue Service in CCA 200614006 takes the position that if a beneficiary of a trust has a property interest under federal law, the Service may use its levy and attachment powers to reach the beneficiary's interest. Under federal common law as well as many state laws, if a beneficiary has an enforceable right to a distribution the beneficiary has a property interest.

ii. UTC & DAPT Exception Creditors

If the UTC or a DAPT allows a child support claim or an alimony claim to attach to a discretionary interest, does this create a property interest under federal law? At present, the answer is probably unknown. However, regardless of whether it is a property interest, if any exception creditor sanctioned by the UTC or a DAPT statute can attach a discretionary interest, so can the federal government. In this respect, a federal creditor can now reach a discretionary beneficiary's interest in the states that allow exception creditors.

iii. Alaska and Nevada

Again, presently the author is unaware of any author or authority that takes the position that a governmental claim is an act of independent significance. In this respect, until further authority is provided on this issue, conservative estate planners may wish to use only Alaska or Nevada if they are attempting to draft around the estate inclusion issues of a self-settled estate planning trust.

The table on the following page details various state law regarding attachment of a DAPT interest.

Certain UTC proponents incorrectly state that a creditor may attach a discretionary trust interest under common law. These UTC authors miscite Section 157.4 of 2A Scott & Fratcher for authority. Section 157.4 is about spendthrift trusts and support trusts. It does not apply to discretionary trusts that are covered in Section 155. The incredible majority opinion as illustrated by the following cases again disagrees with these UTC proponents.

Anglo-American trust law proclaims that when the trustee's powers of distribution are wholly discretionary, the beneficiary has no ownership interest in the trust assets." The *Bass* court further held that a creditor could not attach a discretionary interest, nor could a trustee be required to give 72 hours notice before a distribution is made.

California: *Estate of Canfield*, 181P.2d 732 (Cal. App. 1947).

Colorado *U.S. v. Delano*, 182 F.Supp.2d 1020 (D. Colo. 2001), "However, such a lien cannot attach to property in which the taxpayer has no "property" interest. *Aquilino v. United States*, 363 U.S. 509, 512, 80 S.Ct. 1277, 4 L.Ed.2d 1365 (1960); *Carlson*, 580 F.2d at 1369." *In re Jones*, 812 P.2d 1152 (Colo. 1991) In a discretionary trust, "neither the corpus nor the income may be reached by his [a beneficiary's creditors] until a distribution occurs." Further, the court states, "the interest in a discretionary trust is not assignable and cannot be reached by his or her creditors." Citing *G. Bogert, Trusts*, § 41 (6th ed. 1987).

Connecticut *Spencer v. Spencer*, 802 A.2d 215 (Conn. App. 2002). Also see *Foley v. Hastings*, 139 A. 305 (Conn. 1927).

District of Columbia *Morrow v. Apple*, 26 F.2d 543 (1928).

Iowa *In re Estate of Tone*, 39 N.W. 2d 401 (1949); *Kifner v Kifner*, 171 N.W. 590 (Iowa 1919); *Roorda v. Roorda*, 300 N.W. 294 (Iowa 1941). It is uncertain whether Iowa's Trust Code now allows attachment of a discretionary trust. ICA § 633A.2302 provides for certain exception creditors, but ICA § 633A.2305 provides that these exception creditors may not force a distribution. The Iowa Trust Code is silent whether they may attach a discretionary interest.

Illinois *First of America Trust Co. v. U.S.*, 1993 WL 327684 (C.D. Ill. 1993) – not reported.

Kansas *Watts v. McKay*, 162 P.2d 82 (1945). The Kansas UTC has reversed this case holding. KS St. § 58a-501.

Kentucky *Calloway v. Smith*, 186 S.W. 2d 642 (1945); *Davidson's Ex'rs v. Kemper*, 79 Ky 5, 1880 WL 7269 (Ky. App. 1880); *Tood's Ex'rs v. Todd*, 86 S.W.2d 168 (Ky. App 1935).

Maryland *First Natl Bank v. Department of Health & Hygiene*, 399 A.2d 891 (1979).

- Massachusetts *Brown v. Lumbert*, 108 N.E. 1079 (Mass. 1915); *Iasigi v. Shaw*, 45 N.E. 627 (Mass 1897); *Morel v. Cornell*, 125 N.E. 575 (Mass. 1920).
- Michigan *Miller v. Department of Mental Health*, 442 N.W. 2d 617 (Mich. 1989).
- Minnesota *U.S. v. O’Shaughnessy*, 517 N.W.2d 574 (Minn. 1994) “Under Minnesota law, the beneficiary of a discretionary trust . . . does not have property or any right to property in the nondistributed principal or income before the trustees have exercised their discretionary power.” Later in the opinion, “Creditors who stand in the shoes of the beneficiary, have no remedy against the trustee until the trustee distributes the property.” Therefore, a federal tax lien could not attach to the discretionary trust.
- New Hampshire *Anthorne v. Anthorne*, 128 A.2d 910 (1957). The New Hampshire UTC has reversed this case holding. N.H.Rev. Stat. 564-B:5-501 & 504.
- Ohio *Domo v. McCarthy*, 612 N.E.2d 706 (Ohio 1993), “the discretionary nature of the substituted trust prevents creditors, including Domo, from attaching James Souffer, Jr.’s interest in the James Stouffer, Sr. trust.” Also, see *In re Eley*, 331 B.R. 353 (SD Ohio 2005) noting a discretionary trust is equally effective against creditors as a spendthrift provisions. *Morris v. Daiker*, 172 N.E. 540 (Ohio App. 1929).
- Pennsylvania *Keyser v. Mitchell*, 67 Pa. 473 (1871) “Where the amount results from the discretion of the trustee, and that discretion is personal, no sum, economic benefit, exists to be attached.” This case has been reversed by the Pennsylvania UTC. 20 Pa. Code § 7741 & 7744.
- Rhode Island *Petition of Smyth*, 139 A. 657 (1927), “If the trustees have discretion to withhold income from the beneficiary, he has no vested interest and the income can neither pass by assignment nor be reached by the creditors . . .”
- South Carolina *Collins v. Collins*, 122 S.E. 2d 1 (1961). This case has been reversed by the South Carolina UTC. S.C. Code 1976 § 62-7-501 & 504.
- Tennessee *In re Elsea*, 47 B.R. 142 (Bkrcty Ten. 1985), “A debtor’s interest in a discretionary trust is free from the claims of his creditors because the trustee’s discretion as to whether to make payments deprives the beneficiary of any interest that can be anticipated. *Restatement (Second) Trusts §§ 154 & 155 (1959)*. This case has been reversed by the Tennessee Uniform Trust Code. T.C. § 35-15-501 & 504.
- Texas *Bass v. Denney* cited above as the majority rule. Some other cases are *In re Pratt*, 47 B.R. 142 (Bkrcty. Tenn. 1985); *In re Watson*, 325 B.R. 380 (Bkrcty S.D. Tex. 2005); *Texas Commerce Bank Nat. Assn. v. U.S.*, 908 F. Supp. 453 (S.D. Tex. 1993).

Whereas, the UTC in Kansas, New Hampshire, Pennsylvania, South Carolina, and Tennessee have reversed these states case law that prevented a creditor from attaching a discretionary interest in trust, the following UTC states have modified the national UTC so that a creditor could not attach a discretionary interest:

Florida	Fla. St. § 736.0501 & § 736.0504
Missouri	M.S. 456.5-504. However watch out for the possible enforceable right if there is any ascertainable standard under Section 814(a).
Ohio	OH St. 5805.03 for its definition of a very limited wholly discretionary trust.
Wyoming	Wyo. St. § 4-10-504. However, Wyoming UTC provisions § 4-10-503 regarding the child support exception creditor appears to be in conflict with § 4-10-504. If so, then a federal claim could also attach to a Wyoming discretionary interest. This problem is compounded in that Wyoming statute does <u>not</u> state that a discretionary interest is neither an enforceable right or a property interest.

In addition to the above four UTC states, lead trust Jurisdictions also preventing the attachment of a discretionary interest by statute are:

Delaware	12 Del. Code § 3536
South Dakota	§ 55-1-26(2). However, South Dakota's discretionary-support statute is in direct conflict regarding exception creditors with it DAPT act. How a court will interpret this is unknown.