

The Completed Gift Asset Protection Trust

by Bruce Givner, Esq.
Simon Singer, CFP

Abstract: *The \$5 million per person unified credit against estate and gift tax that went into effect on January 1, 2011, and continues until December 31, 2012, provides an unusually attractive planning opportunity for parents. They can now achieve the following goals in one structure: keep assets available for themselves; protect those assets from their own potential future creditors; pass the assets to their heirs free of estate, gift, and generation-skipping transfer taxes; provide long-term care insurance for themselves and their heirs; and provide large amounts of liquidity for their heirs with which to pay estate tax.*

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Introduction

The clients of financial service professionals may express many different goals when discussing planning, such as:

1. The orderly transmission of wealth upon death, often referred to as estate planning
2. The reduction of estate taxes that often accompanies the estate planning goal (However, estate tax planning has been reduced in importance¹ for many clients due to the \$5 million gift and estate tax exclusion that became effective on January 1, 2011, and continues in force until at least December 31, 2012.²)
3. The protection of assets from future creditors³ for the benefit of the clients
4. The protection of assets for the benefit of children and later heirs
5. The reduction of ordinary income and capital gains taxes, though it is often at odds with transfer tax planning⁴
6. Perpetuation of social values that are important to the client
7. Mentoring the clients' heirs
8. Maintaining the clients' own standard of living from now until the day they die
9. Retaining control of everything during their lifetimes⁵
10. Accomplishing all of those objectives while maintaining simplicity⁶

The financial service professional is skilled in working with other planning team members to help the client accomplish these goals. The estate planning lawyer will draft the documents, such as the "living" trust to accomplish the estate planning goal.⁷ The lawyer can also draft various irrevocable trusts to accomplish the estate tax

planning, asset protection planning, and values-related goals. The accountant will perform calculations of projected estate taxes and cash flows, comparing the results both before and after the proposed planning. The accountant may also, alone or in conjunction with the lawyer, prepare income and transfer tax returns for the clients, trusts, and related entities, e.g., family limited partnerships (FLPs). The trust officer will provide financial guidance for the trusts over time, and a bank related to the trust company may also provide financing for family transactions, e.g., purchases of interests in family entities such as an FLP or LLC.⁸

However, the planning team only comes together once the client is motivated to engage in planning and, in that respect, the financial service professional is often the initiator. Despite letters from the lawyer and the accountant inviting the client to initiate a planning discussion, the client may shy away from engaging those members of the planning team due to the often hourly paid nature of their compensation. Even if the financial service professional is compensated on an hourly basis, which many are not, the hourly rate is often a fraction of that charged by the lawyer and the accountant. Therefore, it is important for the financial service professional to have an idea of the range of possibilities available to meet the client's varied, sometimes seemingly contradictory, goals. Otherwise, the apparent contradictions may keep the client from beginning the planning process in the first place.

Estate Planning

Estate planning can be viewed as a discussion of how the clients wish to transmit assets to the desired people in the proper fashion at the least cost and complexity. To accomplish this, most clients with whom the financial service professional has contact will already have a "living" trust in place. Clients are usually comfortable with this trust because they know that they can amend or revoke the trust anytime they wish, as often as they wish, as long as they are alive. In other words, they maintain dictatorial control over the disposition of their assets even though the assets are governed by a trust. In the case of a married couple, they also have some idea that the trust accomplishes estate tax savings, even if they are not pre-

cisely sure how that happens.⁹ This familiarity with a trust often makes it difficult for clients to feel comfortable with irrevocable trusts, which are needed to engage in estate tax and asset protection planning. Why would the client want to set up a trust that he/she cannot amend or revoke? Why would that sound appealing to the client? What if the client's feelings about some important feature of that trust changes? The possibility of a change in feelings or circumstances, without the ability to change the transfer, is an unsettling proposition.

Estate Tax Planning

There are ways to accomplish estate tax planning that do not require an irrevocable trust. For example, the parents can make an outright gift to the children or other heirs. That will remove future income¹⁰ and appreciation on the assets from the parents' estate. Also, the value transferred by a gift may be leveraged using irrevocable trusts authorized by Congress, such as a qualified personal residence trust (QPRT) and a grantor retained annuity trust (GRAT).¹¹ The value transferred can be further amplified when the assets are interests in family enterprises, such as FLPs and LLCs, due to the well-respected adjustments to value such as the lack of marketability and lack of control.¹² There are also structures that can leverage the value and take advantage of the valuation adjustments that, although not prescribed by Congress, have considerable authority, such as sales for a private annuity or a self-canceling installment note,¹³ or a sale to a grantor trust.¹⁴

Gift Tax Planning

The January 1, 2011, increase of the lifetime transfer tax exclusion gives financial service professionals a reason to schedule meetings with clients to discuss the new, potentially temporary, gifting opportunity. However, at the conclusion of a meeting about the exciting new gift opportunity, the client may ask, "What if I need the assets in the future? Can I get them back?" The normal answer might be that, to reduce estate tax, the gifts must be completed transactions. To the extent the client retains an interest in the gifted property, the IRS may assert that the asset should be included in the client's estate.¹⁵ Upon hearing this response, the client may express appre-

ciation for the information and agree to consider the gifting opportunity. However, when the financial service professional tries to schedule a follow-up appointment, the client may not respond. Sometimes the failure to respond is simple inertia. Often, however, the failure to respond is due to the client's fear that he/she will change his/her mind about the transfer. That change of mind may be due to a change of feeling about the beneficiaries or may be based on a change in the client's own financial situation that will make him/her need the gifted assets or related income.

Conflicts

A complete understanding of the gifting opportunity requires a discussion of two conflicts. The first is the conflict between having assets available for the client's own use and protecting the assets from the client's future creditors. The second is the conflict between having the assets available for the client's own use and making a completed gift for transfer tax purposes.¹⁶ For many clients either conflict ends the gift tax-planning discussion (if it does not prevent the discussion from occurring in the first place).

The first conflict is created by a rule of the common law, which originated in England in the Middle Ages: the rule against self-settled spendthrift trusts. It prevents the client from establishing a trust with the client's own assets, with the client as the beneficiary, in which the assets are protected from the client's creditors.¹⁷ Many jurisdictions outside the United States have repealed the rule.¹⁸ As a result, many U.S. citizens created non-U.S. trusts to allow them to both retain access to assets and protect the assets from future creditors. However, before 1997, almost all U.S. states had statutory or case law that implemented the common law rule against self-settled spendthrift trusts.¹⁹ As a result, most clients who were uncomfortable with the idea of establishing a non-U.S. trust were unable to pursue the seemingly conflicting goals.

On April 1, 1997, Alaska adopted a new law expressly providing that creditors of the settlor²⁰ could not reach assets that the settlor had transferred to a self-settled discretionary spendthrift trust.²² Later in 1997, Delaware and Nevada²³ followed with similar statutes.²⁴ Since then, other states have enacted what are referred to

as DAPT (domestic asset protection trust) statutes. Most of the impetus behind these laws was to compete with the offshore asset protection jurisdictions. However, once the initial flurry of interest subsided, it became apparent that resolution of the second conflict was also available using these newly available domestic trusts.

The second conflict—having the assets available yet making a completed gift—is created by the fact that normally having trust assets available to the trust creator causes estate tax inclusion. For example, the client's "living" trust is included in the client's taxable estate because the client has the ability to amend and revoke the trust. Internal Revenue Code §2038, titled "Revocable transfers," provides, in part, that:

The value of the gross estate shall include the value of all property...To the extent of any interest therein of which the decedent has at any time made a transfer...where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power...alone or...in conjunction with any other person to alter, amend, revoke or terminate....

Assume that instead of a regular "living" trust the client establishes a self-settled spendthrift trust under the laws of a state like California that does not respect the limit on transfers in favor of the trust's creator. Under that trust the client gives up the right to revoke or amend the trust, and the trustee is given discretion to distribute income and principal to a class of beneficiaries that includes the client. The trust's assets would be included in the client's estate because the client's creditors could reach the trust's assets.²⁵

However, a different result occurs if the client establishes a self-settled discretionary spendthrift trust in Nevada or Alaska, the states with the most favorable DAPT legislation.²⁶ State law prevents the client's creditors from having access to the trust's assets, a result in which the transfer is a completed gift. Although private letter rulings may not be cited by other taxpayers, the IRS viewed the transfer to an Alaskan DAPT in Private Letter Ruling 9837007 as a completed gift. In that ruling an Alaska resident created a self-settled spendthrift trust in which the trustee had complete discretion as to the distributions of principal and income. The IRS determined that:

Based on the representation that there is no express or implied agreement between the Donor and the Trustee as to how Trustee will exercise its sole and absolute discretion to pay income and principal among the beneficiaries, we conclude that the proposed transfer by Donor of property to Trustee to be held under the Trust agreement will be a completed gift for federal gift tax purposes.

The ruling's language gives rise to the name of the structure: the completed gift asset protection trust, or completed gift DAPT. However, the IRS cautioned that it was "expressly not ruling on whether the assets held under the trust agreement at the time of Donor's death will be includible in Donor's gross estate for federal estate tax purposes."

Estate Tax Exclusion

Again, private letter rulings may not be cited by other taxpayers. However, in Private Letter Ruling 200944002, the IRS addressed the estate tax issue involving an Alaska trust with a completely independent Alaska trustee that had complete discretion as to distributions. The IRS ruled that "the trustee's discretionary authority to distribute income and/or principal to Grantor does not, by itself, cause the Trust corpus to be includible in Grantor's gross estate under §2036." Of course, the IRS left open the possibility that the trustee's discretion, "combined with other facts (such as, but not limited to, an understanding or preexisting arrangement between Grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under §2036."

Example: Assume that Harold and Wanda are worth \$20 million consisting of a \$1 million residence, a \$6 million closely held business, \$2 million in retirement accounts, interests in an FLP that owns investment real estate worth \$3 million, and an \$8 million managed portfolio. They filed federal gift tax returns (IRS Form 709) using their then existing \$1 million per person gift exclusion when they established the FLP (Figure 1).

Harold and Wanda are young, ages 55 and 50, and their business generates \$600,000 per year in compensation. They receive \$200,000 per year as their share of the FLP's income. All of this income is substantially in excess

of what they need to maintain their standard of living. As a result, their net savings increases each year.

The financial service professional suggests that they consider taking a step to capture the additional \$4 million per person gift tax exclusion but keep the assets available in the unlikely event that they need them in the future. Harold and Wanda, based on this discussion, meet with their estate planning attorney and establish a self-settled spendthrift trust (in an appropriate jurisdic-

FIGURE 1

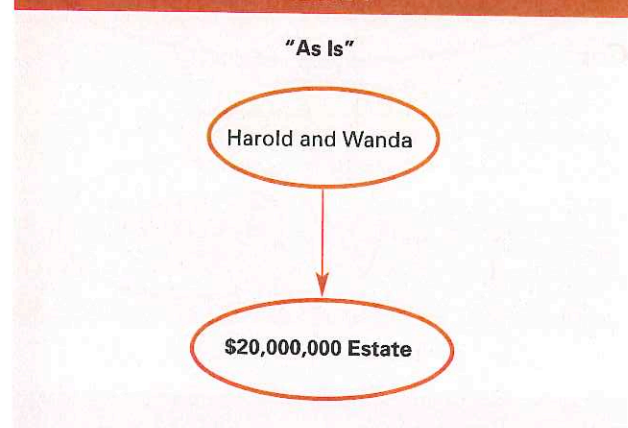
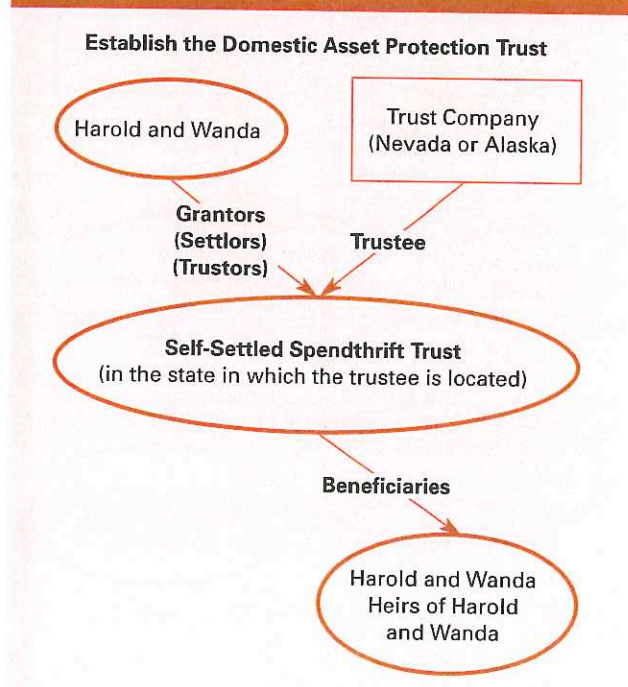
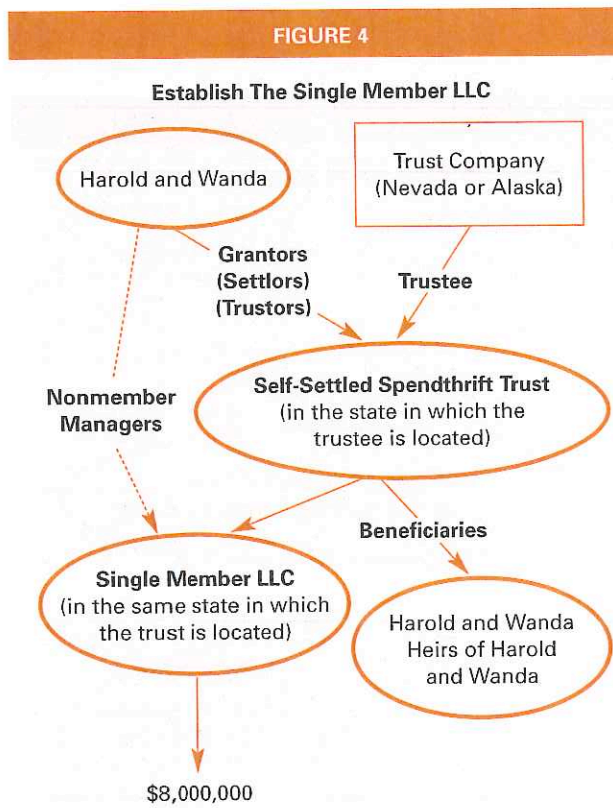
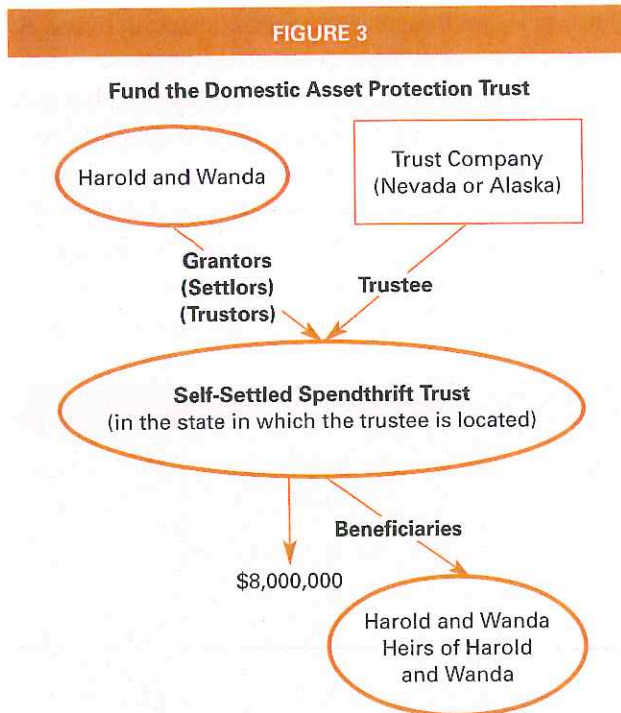


FIGURE 2





tion) with an independent trustee and a distribution advisor²⁷ who has complete discretion over the distribution of principal and income to a class of beneficiaries that includes Harold, Wanda and their heirs (Figure 2).

They also meet with their accountant who prepares federal gift tax returns (IRS Form 709) to reflect the new gifts (\$8 million total). As a result, the assets are outside their taxable estate (Figure 3).

Continued Investment Management.

Assume Harold and Wanda do not wish to give up their ability to manage the investment of the transferred assets to the independent trustee. Therefore, they direct their attorney to create a single-member LLC in the same state where the trust is established. The self-settled spendthrift trust becomes the sole member of this LLC. Harold and Wanda, as individuals, become the nonmember managers of the LLC. The LLC is a disregarded entity for federal income tax purposes,²⁸ though it may need to file a return and pay a franchise tax in the state.²⁹ The status that Harold and Wanda have as managers is not an asset that can be taken from them by a creditor, just as being president of a corporation is not an asset (Figure 4).

Asset Protection for the Parents

A thorough discussion of the issues related to asset protection planning is beyond the scope of this article. For example, Harold and Wanda must not transfer assets with the intent to delay or defraud a creditor.³⁰ They must take care that the trustee acts with independence so that the trust is not held to be their alter ego.³¹ Harold and Wanda must also be aware of the fact that under the Bankruptcy Reform Act of 2005,³² there is now a 10-year period during which a bankruptcy trustee may attack as fraudulent a transfer to “a self-settled trust or similar device.”³³

First, assume that Harold and Wanda are residents of a state such as Delaware that has an attractive self-settled spendthrift trust law but has an exception for child support orders and preexisting tort claims. This arguably allows Harold and Wanda to “relegate” their creditors to the DAPT assets.³⁴ As a result, the IRS might try to use Internal Revenue Code §§2036 and 2038 to include the DAPT assets in their taxable estate.³⁵

Second, assume that Harold and Wanda are not res-

idents of the state with the favorable DAPT legislation but choose to establish a trust in such a state. Therefore, if they are sued by a creditor in their state of residence, the creditor will likely argue that the court should apply the law of the state of residence in determining whether the DAPT assets are subject to the creditor's judgment. That issue has not yet been authoritatively determined and probably depends upon the facts of each situation.³⁶ However, Harold and Wanda take comfort from their counsel's advice that the DAPT's existence is likely to give a future creditor pause and, after all, the realistic goal of creditor protection planning is to induce a future judgment creditor to settle for pennies on a dollar. A successful creditor, when faced with a well-drafted, well-operated DAPT established long before any sign of trouble, is likely to agree to settlement discussions.

Long-Term Care Protection

The client has three approaches in covering long-term care costs: (1) self-insuring all costs relating to long-term care, (2) buying a traditional long-term care policy with a guaranteed or nonguaranteed annual premium, and (3) repositioning liquid assets in an asset based insurance approach in which the client continues to self-insure a portion (the repositioned assets) and coinsure the remaining balance (the purchased coverage).³⁷

Although liquid assets in the DAPT can be used for all three approaches, the third approach is particularly suited to a trust in which the clients want the assets to remain available in case they need them in the future. That is because certain policies of this type may be canceled at any time, with the premiums returned in full.

Estate Liquidity

Similar to the long-term care discussion, the completed gift DAPT can be used to provide liquidity for the clients' estate in four ways:

1. The DAPT's liquid assets can directly provide the liquidity.³⁸
2. The DAPT can acquire life insurance on the clients' lives.
3. The DAPT can enter into a split-dollar arrangement with an irrevocable life insurance trust that will own the policies.

4. The DAPT's liquid assets can be repositioned into life insurance policies that have a cash surrender value equal to (or nearly equal to) the premiums paid.

Again, although the DAPT's liquid assets can be used in all four approaches, the fourth approach is particularly suited to a trust in which the clients want the assets available to them in the future in case their financial situation deteriorates.

Reducing State Income Taxes

Each state has its own rules for taxing trust income.³⁹ The completed gift DAPT above can be structured to reduce or eliminate state income tax in some situations. For example, California taxes trust income based on the residence of the trustee and of the beneficiary at a rate of up to 10.3% on income over \$1 million.⁴⁰ A completed gift DAPT that uses a non-California trustee, non-California beneficiaries such as a charity, and a California beneficiary that is only a contingent beneficiary because the trustee has discretion as to distributions, may eliminate the California tax, at least until distributions are actually made to the California beneficiary.⁴¹ Similarly, New York will not tax a trust that has no New York trustees, New York assets, and New York source income.⁴² That is especially helpful since a New York City resident trust is taxable at a rate of up to 10.498%.⁴³

Conclusion

The newly increased \$5 million "basic exclusion amount"⁴⁴ provides a wonderful opportunity for the financial service professional to engage in broad-ranging discussions with clients about their goals and objectives. The completed gift asset protection trust can help clients accomplish goals previously thought to be conflicting: making completed gifts for transfer tax purposes while keeping the assets available to themselves. That flexibility will encourage more clients to engage in sophisticated planning. To the extent that the financial service professional is the initiator of those discussions, the other members of the planning team will be enthusiastic participants and grateful to the financial service professional. Much of that sophisticated planning may well involve the type of assets

with which the clients will need the financial service professional's guidance. ■

Bruce Givner, Esq., of Givner & Kaye, Los Angeles, is the author of or contributor to six books on tax planning, the most recent of which is *Drafting California Irrevocable Trusts* (3rd edition, 2010), *Continuing Education of the Bar – California*, chapter 17, "Qualified Personal Residence Trusts." He may be reached at bruce@givnerkaye.com.

Simon Singer, CFP, of the Advisor Consulting Group in Encino, California, is a past president of the Forum 400 (previously known as the International Forum), a Life member of the Top of the Table and MDRT, a member of the International Association of Financial Planners, a member of Advisors in Philanthropy, and is the coauthor of three books on financial planning. He may be reached at simon@advcg.com.

(1) Estate tax planning has been reduced in importance in two senses.

First, the absolute number of families whose estates will be affected by the estate tax is going to drop precipitously. For comparison, the total number of estate tax returns (IRS Form 706) filed for all decedents between 2001 and 2007 fell from 108,071 to 38,031, due primarily to increases in the estate tax exemption. In 2001 the exemption was \$675,000, and it increased to \$2 million in 2007, IRS Statistics of Income Bulletin 29 (No. 2): 302. No reliable estimates have been published of the number of estate tax returns expected to be filed with a \$5 million exclusion. However, Professor Jeffrey Pennell suggested at the 2011 U.S.C. Tax Institute that only 1/7th of 1% of the population will be impacted. With a U.S. population estimated at 311,000,000 (<http://www.census.gov/main/www/popclock.html>), that is about 440,000 people. Assume that the average life expectancy is 80. (For comparison, the §1.401(a)(9) 2002 table used for some tax purposes indicates that a person age 0 has an 82.4 year life expectancy, and a person age 60 has a 25.2 year life expectancy.) That means that there are 5,500 people at each age one through 80. If the equivalent of one age group will die per year, and a portion of that age group is the first spouse to die of a married couple, the number of estate tax returns that will generate an estate tax will be significantly less than 5,500 per year.

Second, many estates that will be subject to estate tax will be reduced by a significantly smaller tax. Consider the following examples:

Single Person			
Net estate	2009 estate tax	2011 estate tax	Percent reduction
\$3,500,000	\$0	\$0	0
\$5,000,000	\$675,000	\$0	100%
\$10,000,000	\$2,925,000	\$1,750,000	40%
\$20,000,000	\$7,425,000	\$5,250,000	30%
\$50,000,000	\$20,925,000	\$15,750,000	25%
\$100,000,000	\$43,425,000	\$33,250,000	23%

Married Couple (survivor's death using unlimited marital deduction)			
Net estate	2009 estate tax	2011 estate tax	Percent reduction
\$7,000,000	\$0	\$0	0
\$10,000,000	\$1,350,000	\$0	100%
\$20,000,000	\$5,850,000	\$3,500,000	40%
\$50,000,000	\$19,350,000	\$14,000,000	28%
\$100,000,000	\$41,850,000	\$31,500,000	25%

The examples demonstrate that the percentage reduction in tax is more dramatic for estates under \$20 million. However, it is still significant at higher estate values simply because 35% (the new maximum rate) is 77.77% as high as the old maximum rate of 45%. Therefore, at every size estate there will be at least a 22.23% reduction in the estate tax due. In other words, a \$10 million+ reduction in estate tax for someone worth \$100 million is likely to be significant.

(2) Internal Revenue Code §2010(c), as amended by §§302 and 303 of P.L. 111-312 and P.L. 107-16, EGTRRA (Economic Growth and Tax Relief Reconciliation Act of 2001). Will Congress allow the \$5 million exclusion to "sunset" and return to \$1 million? Of course no one knows for sure. A poll of tax professionals is likely to find a significant number who believe that it will be politically difficult for Congress to allow the exclusion, once it has attained \$5 million, to go back to a lower number. The thinking is that allowing such a reduction would be akin to a vote to continue the "death tax," which is a hot button for a great part of the electorate. Also, current trends suggest that the Republican party will take control of the U.S. Senate in the 2012 elections. If the Republicans also take control of the presidency, the Republican party will be under tremendous pressure to deliver on a long-term promise to repeal the "death tax" (see <http://www.gop.com/2008Platform/Economy.htm>). By contrast, there are many tax professionals who feel that the mounting pressure to reduce the long-term federal deficit will renew interest in the estate tax as an inoffensive way, since it impacts such a small portion of the population—which is easily identified as wealthy—to raise revenue. All of this is pure speculation.

(3) The phrase "future creditor" is used to emphasize that actions cannot be taken to protect assets from someone who is a current creditor. A "creditor" means "a person who has a claim..." (California Civil Code §3439.01(c), which is California's version of the Uniform Fraudulent Transfer Act). As an example of how "uniform" the "Uniform Fraudulent Transfer Act" is, Arizona's version has an almost identical definition at §44-1001.3. See Also Alabama §8-9A-1(4).

(4) The normal example of how the transfer tax and income tax are incompatible involves appreciated property. If the parent gives the property to the child during the parent's lifetime, then the future appreciation escapes estate tax. However, the child's income tax basis in the property is the same as the parent's basis. By contrast, if the parent dies owning the property, the property's value is included in the parent's estate for estate tax purposes, but the child receives a date-of-death income tax basis. So, the choice is often estate tax exclusion but lower basis versus estate tax inclusion but step up in basis to date of death fair market value.

(5) This goal is also at odds with transfer tax planning since “control” is usually the equivalent of ownership for transfer tax purposes. Therefore, the role of the counselor is to make the clients comfortable that a bundle of rights that falls short of control/ownership is enough to allow the client to move forward with the planning. Justice Benjamin Cardozo is credited with first using the “bundle of sticks” analogy to ownership. In “The Paradoxes of Legal Science,” in *Selected Writings of Benjamin Nathan Cardozo*, 251, 331 (M. Hall ed. 1947), Cardozo stated that “[t]he bundle of power and privileges to which we give the name ownership is not constant through the ages. The faggots must be put together and redound from time to time.”

(6) Of course simplicity is mutually exclusive with sophisticated planning, and this is one of the principal hurdles that must be overcome. However, the financial service professional can be helpful in explaining to the client the cost/benefit analysis of the planning, that some complexity is required to achieve the important goals and objectives and that, with highly competent members of the planning team, much of the burden for ongoing compliance will not be shouldered by the client.

(7) These trusts are also referred to as *inter vivos* (Latin for “among the living”), revocable, and family trusts. The main point is that they are “will substitutes” insofar as they are the primary document by which the client’s assets are distributed at death. This type of trust started replacing wills as the primary dispositive documents in the mid-1970s. Now most families have this type of trust in combination with “pourover” wills. The primary purpose of a pourover will is to transfer to the “living” trust any assets not already “in” the trust at the decedent’s death. The primary purpose of the trusts is to (1) avoid the need for a conservatorship if the grantor becomes incompetent, and (2) avoid the need for a probate at death. The desire to avoid probate is motivated by concerns about the costs, delays, and public nature of a probate proceeding. Note that a person’s living trust is usually not named in this manner: the John Jones Living Trust. After the death of John Jones that title for his trust becomes awkward. So the more common appellations include the John Jones Family Trust, the John Jones Revocable Trust, the John Jones 2011 Trust or simply the John Jones Trust. See Streng, 800-2nd T.M., Estate Planning, ¶V.B.2.c.

(8) See Mezzullo, 812-3rd T.M., Family Limited Partnerships and Limited Liability Companies.

(9) The estate tax savings comes from the fact that upon the first spouse’s death, an amount equal to that spouse’s unused lifetime transfer tax exclusion is separated into a credit shelter trust. (That trust is sometimes referred to as the bypass trust, the exclusion trust, the decedent’s trust, the B trust, and even, confusingly, the family trust.) The survivor is (1) often the trustee of the credit shelter trust, (2) often the sole income beneficiary of the credit shelter trust, and (3) able (as trustee) to invade the credit shelter trust principal based on a HEMS (health, education, maintenance and support) standard. However, even if the couple did not have a “living” trust, the same credit shelter trust could be established in wills that they would almost certainly have. Therefore, the idea that “a living trust saves estate tax” is, at best, simplistic and, in the case of a single person, untrue.

(10) If the donee is less than the age of 24 years, the “kiddie tax” may

thwart the goal of reducing income tax. IRC §1(g).

(11) See Blattmachr, Slade and Zeydel, 836-2nd T.M., Partial Interests – GRATs, GRUTs, QPRTs (Section 2702).

(12) See Hood, 830-2nd T.M., Valuation: General and Real Estate, ¶II.H. Proposals have been made to eliminate certain valuation discounts. See, for example, H.R. 436, Certain Estate Tax Relief Act of 2009, introduced January 9, 2009.

(13) See Wojnaroski, 805-3rd T.M., Private Annuities and Self-Canceling Installment Notes.

(14) See, for example, Keebler and Melcher, “Structuring IDGT Sales to Avoid §§2701, 2702 and 2036,” *Estate Planning* (October 2005): 19. The phrase “defective trust” is often used in reference to a grantor trust. However, most attorneys are unlikely to admit to drafting a “defective” trust, so the phrase “grantor trust”—which seems to spring directly from relevant Internal Revenue Code sections—is used in the text. See IRC §§671 – 679.

(15) The most likely argument would be based on IRC §2036, entitled “Transfers with retained life estate,” which provides, “The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer...under which he has retained for his life...(1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.” This is the powerful weapon the IRS has been using successfully against some poorly operated FLPs. See *Estate of Miller v. Commissioner*, T.C. Memo 2009-119, in which the *bona fide* sale for full and adequate consideration exception to §2036 was held to apply to transfers of marketable securities to an FLP made 13 months before the decedent’s death because there were legitimate and significant nontax reasons for the contributions. However, the court refused to apply that exception to contributions made only 13 days before the decedent’s death after very serious health problems. As to those assets, the court held that §2036(a)(1) applied. There is an exception for a transfer made for “adequate and full consideration in money or money’s worth.” In other words, if the parent sells a home to the child for appraised fair market value, the parent could, at least in theory, remain living in the home as long as the parent paid the child fair rental value for the right to live in the home. This is a difficult example since, in this type of transaction, the IRS will closely scrutinize the facts and the family may not have carefully documented each detail. For example, was there a written lease? Was the lease for a term that was appropriate in the market place? Was there an appraisal to determine the fair market rent?

(16) The phrase “transfer taxes” subsumes within it the gift tax, estate tax and generation-skipping transfer tax.

(17) The rule against self-settled spendthrift trusts finds its roots in a 1487 English statute, which states that “[a]ll deeds of gift of goods and chattels, made or to be made in trust to the use of that person or persons that made the same deed or gift, be void and of none effect.” This rule does not depend on the settlor’s intent (or lack thereof) to defraud creditors existing or future. Veit, “Self-Settled Spendthrift Trusts And The Alaska Trust Act: Has Alaska Moved Offshore?” *Alaska L. Rev.* 16: 269, 274.

(18) §13F(1) of the Cook Islands International Trusts Act provides as follows: “For the purposes of this Act, and notwithstanding any rule of law or equity to the contrary, it shall be lawful for an instrument or disposition to provide that any estate or interest in any property given or to be given to any beneficiary shall not during the life of that beneficiary, or such lesser period as may be specified in the instrument or disposition, be alienated or pass by bankruptcy, insolvency or liquidation or be liable to be seized, sold, attached, or taken in execution by process of law and where so provided such provision shall take effect accordingly.” See also §13C, titled “Retention of control and benefits by settlor.”

(19) See, for example, California Probate Code §15302(a): “If the settlor is a beneficiary of a trust created by the settlor and the settlor’s interest is subject to a provision restraining the voluntary or involuntary transfer of the settlor’s interest, the restraint is invalid against transferees or creditors of the settlor. The invalidity of the restraint on transfer does not affect the validity of the trust.” See §112.035 of the Texas Property Code: “If the settlor is also a beneficiary of the trust, a provision restraining the voluntary or involuntary transfer of his beneficial interest does not prevent his creditors from satisfying claims from his interest in the trust estate.”

(20) The creator of a trust is referred to as the settlor, trustor or grantor.

(21) To achieve creditor protection, the trust creator’s interest in the trust must be subject to the discretion of an independent third-party trustee. Were it otherwise—if the trust creator’s interest in trust assets was mandatory, e.g., all income must be distributed annually to the grantor—then the trust creator’s creditors could attach the income as it is distributed.

(22) Alaska Stat. §34.40.110.

(23) Chapter 166 of the Nevada Revised Statutes is titled “Spendthrift Trusts,” so the topic gets a great deal of coverage. §166.020 defines a “spendthrift trust” to be “a trust in which by the terms thereof a valid restraint on the voluntary and involuntary transfer of the interest of the beneficiary is imposed. It is an active trust not governed or executed by any use or rule of law of uses.” The general tone of the protection for spendthrift trusts is evident in N.R.S. §166.120(2): “Payments by the trustee to the beneficiary shall be made only to and into the proper hands of the beneficiary and not by way of acceleration or anticipation, nor to any assignee of the beneficiary, nor to or upon any order, written or oral, given by the beneficiary, whether such assignment or order be the voluntary contractual act of the beneficiary or be made pursuant to or by virtue of any legal process in judgment, execution, attachment, garnishment, bankruptcy or otherwise, or whether it be in connection with any contract, tort or duty.” However, there is a great deal of other such supportive language.

(24) A chart that describes these statutes can be found in Shaftel, “A Comparison of the Various State Domestic Asset Protection Trust Statutes,” *Estate Planning* 35 (March 2008): 3; Shaftel, “Variations in State Domestic Asset Protection Statutes Compared,” *Estate Planning* 35 (April 2008): 14; and *ACTEC J.* 34 (2009): 293.

(25) Rev. Rul. 76-103, 1976-1 C.B. 293, citing Alice Spaulding Paolozzi, 23 T.C. 182 (1954), *acq.* 1962-1 C.B. 4, for the proposition that no taxable gift occurs when the grantor is able to “relegate” the grantor’s creditors to the trust for the purpose of paying their claims.

(26) The rules are not uniform among the states. For example, Nevada and

Alaska do not have exceptions for preexisting torts, alimony, or child support. Alaska does allow a divorcing spouse to have access to a DAPT. By contrast, Delaware and South Dakota have exceptions for preexisting torts and orders for child and spousal support. So it is not clear if the same favorable result would occur in the states with exceptions for other creditors, such as South Dakota, Delaware, Tennessee, Rhode Island, New Hampshire, Wyoming, Utah, Missouri, Oklahoma, Hawaii, and Colorado.

(27) Typically, a DAPT will use a small trust company headquartered in the desired state so that the trust qualifies as a Nevada or Alaska trust. These trust companies charge a modest fee for acting as “trustee” as long as they do not have custody of the assets. If they are given custody of the assets, an asset-based fee applies, usually beginning at 1% of the first \$1 million. The client will want a trusted friend or family member to exercise discretion as to distributions, and this position is often labeled “distribution advisor” in the trust instrument.

(28) Internal Revenue Service Reg. §1.368-2T(b)(1)(i)(A): “Disregarded Entity. A disregarded entity is a business entity (as defined in §301.7701-2(a) of this chapter) that is disregarded as an entity separate from its owner for Federal tax purposes. Examples of disregarded entities include a **domestic single member limited liability company that does not elect to be classified as a corporation for Federal tax purposes**, a corporation (as defined in Section 301.7701-2(b) of this chapter) that is a qualified REIT subsidiary (within the meaning of section 856(i)(2)), and a corporation that is a qualified subchapter S subsidiary (within the meaning of section 1361(b)(3)(B)).” [Emphasis added.]

(29) For example, California charges LLCs an \$800 minimum franchise tax, due with Form FTB 3522, plus a gross receipts tax, due with Form FTB 568, but the estimated fee is payable with Form 3536 and can be as much as \$11,790. The LLC will also have to pay an annual fee for statutory representation to a registered agent. This type of fee may be in the range of \$168 (paid to a Delaware resident agent).

(30) See the discussion of fraudulent transfer rules in endnote 3.

(31) In *In re Yerushalmi*, 2009 WL 2982964 (Bkrtcy. E.D.N.Y.) (Sept. 14, 2009), the court denied defendant’s motion to dismiss the trustee’s request to amend his complaint to pierce the veil of a qualified personal residence trust and declare that it was the judgment debtor’s *alter ego*. In *In re Schwarzkopf*, No. 08-56974 (November 23, 2010 – Ninth Circuit), the court confirmed the lower court’s finding that a trust for the benefit of a disabled minor was the parent’s *alter ego*.

(32) The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, signed into law on April 20, 2005, by President Bush as P.L. 109-8.

(33) Bankruptcy Code §548(e)(1) provides as follows: “(e)(1) In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition, if (A) such transfer was made to a self-settled trust or similar device; (B) such transfer was by the debtor; (C) the debtor is a beneficiary of such trust or similar device; and (D) the debtor made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted. (2) For the purposes of this subsection, a transfer includes a transfer made in anticipation of any money judgment, settlement, civil penalty, equitable order, or criminal fine incurred by,

or which the debtor believed would be incurred by: (A) any violation of the securities laws (as defined in §3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47), any State securities laws, or any regulation or order issued under Federal securities laws or State securities laws; or (B) fraud, deceit, or manipulation in a fiduciary capacity or in connection with the purchase or sale of any security registered under §12 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78l and 78o(d)) or under §6 of the Securities Act of 1933 (15 U.S.C. 77f).” One of the items of most interest is the development of the meaning of the phrase “similar device.”

(34) See endnote 25 and the related text.

(35) Shaftel, “IRS Letter Ruling Approves Estate Tax Planning Using Domestic Asset Protection Trusts,” *Journal of Taxation* (April, 2010): 8; http://shaftellaw.com/docs/article_31.pdf.

(36) For example, if the lawsuit involves a personal injury, it is more likely that a court will find a way to reach the assets that Harold and Wanda have transferred to an out-of-state trust. Why? Because the interest of the state of residence in providing a recovery for the injured resident is likely to be viewed as more important than the other state’s interest in protecting assets in self-settled spendthrift trusts. By contrast, if the lawsuit involves a contract dispute, the judge is more likely to give value to the other state’s interest in protecting its trusts. Also, if the assets in the out-of-state trust are limited partnership interests in a partnership that owns real property in the state of residence, the judge is less likely to shy away from awarding the assets to the judgment creditor because the real estate is clearly subject to the judge’s jurisdiction. However, this is mere speculation as the cases have not yet been decided.

(37) The authors appreciate the help of Barry Boscoe, Brighton Advisory Group, Encino, California with this discussion.

(38) The policy owned by the DAPT cannot be mandated to pay estate taxes. Otherwise, the DAPT would be included in the decedent’s estate. See IRC §2042(1). The policy owned by the DAPT can only be used to provide liquidity for estate taxes in the absolute discretion of the independent trustee.

(39) See generally Nenno, “Planning to Minimize or Avoid State Income Tax on Trusts,” *Issues and Insights For The Advisor* (January 2009), published by Wilmington Trust.

(40) California Revenue and Taxation Code §§17041(a), (e), (h), 17043(a).

(41) Of course, the State of California has a great interest in taxing income of trusts that have any relationship to its residents. Therefore, such a trust must be carefully structured and consideration should be given to filing protective trust income tax returns with the state fully disclosing the structure and even entering into voluntary disclosure agreements with the California Franchise Tax Board. California Revenue and Taxation Code §§19191-19192. §19191(d) provides that the benefit of entering into a voluntary disclosure agreement is that the California Franchise Tax Board will waive its authority to assess taxes and penalties. §19192(a)(7) defines the type of trust that can enter into voluntary disclosure agreement as fol-

lows: “(7) “Qualified trust” means a trust that meets both of the following: (A) (i) The administration of the trust has never been performed in California. (ii) For purposes of this subparagraph, administrative activities performed in California would be deemed to be performed outside of California if those activities were inconsequential to the overall administration of the trust. (B) For six taxable years ending immediately preceding the signing date of the voluntary disclosure agreement, the trust has had no resident beneficiaries (other than a beneficiary whose interest in that trust is contingent: a beneficiary’s trust interest is not contingent if the trust has made any distribution to the resident beneficiary at any time during the six taxable years ending immediately preceding the signing date of the voluntary disclosure agreement).”

(42) Michaels and Twomey, “How, Why and When to Transfer the Situs of a Trust,” *Estate Planning* (January 2004): 28–29.

(43) Nenno, “Planning to Minimize or Avoid State Income Tax on Trusts,” at 10.

(44) That is the technical term used in IRC §2010(c)(3).

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