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ESTATES, TRUSTS, & GIFTS

IRS Letter Ruling Approves Estate Tax Planning Using Domestic Asset Protection Trusts

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Additional flexibility in planning to minimize estate taxes while preserving assets was given a big boost when the Service ruled favorably on a domestic asset protection trust formed under the Alaska statute. Despite the trustee's having the power, in its absolute discretion, to make distributions to the settlor, the IRS concluded the corpus would not be includable in the settlor's gross estate.

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Ltr. Rul. 200944002 represents the first instance in which the IRS has approved the use of a domestic asset protection trust (DAPT) to minimize estate tax. A DAPT is an irrevocable spendthrift trust formed under a state law that authorizes an independent trustee—in the trustee's absolute discretion (or pursuant to certain specific statutory standards)—to make distributions to a class of beneficiaries that includes the settlor. The statute expressly states that the settlor's creditors cannot reach the assets in the trust. The ruling will provide some comfort for taxpayers and estate planners, along with the hope that future rulings may broaden its scope.

INTRODUCTION

Consider the following client situation, which estate planners will experience many times during 2010 and likely also in later years. Your clients have consulted you seeking estate planning guidance. At the time of the consultation, the estate tax has been repealed for 2010 but is scheduled to come back in full force in 2011 with a smaller ($1 million) applicable exclusion amount and a higher (55%) rate than were in effect for several years before 2010. [1] Congress may step in and pass new legislation that might be retroactive to 1/1/10, but it seems unlikely it will permanently repeal the tax.

You discuss with your clients the type of initial planning that will protect both spouses' applicable exclusion amounts from estate tax at the death of the second spouse. You also discuss the anticipated increases in the applicable exclusion amount. Your clients' net worth, however, is significantly greater than twice any anticipated applicable exclusion.

You suggest the following types of planning. A trust will be created for your clients' children, grandchildren, and further descendants. Each year, your clients will make

annual exclusion gifts ($13,000 per year per beneficiary) to the trust. In addition, each client will give the $1 million that his or her applicable credit will protect from federal gift tax.[2] Both the annual exclusion gifts and the applicable credit gifts may consist of interests in the clients' business or investment entities. Significant valuation discounts may be obtained when transferring such assets, at least under current law.[3]

You explain to your clients that after they have maximized their gifts, other techniques or arrangements may well reduce their estate taxes. For example, grantor retained annuity trusts and sales to grantor trusts could be used to transfer business or investment entity interests without significant gift taxes being imposed. Again, valuation discounts and the fact that the values of these entities may be at a low point will maximize the effectiveness of these techniques.

Your clients have listened attentively to your careful presentation. At the conclusion, they ask, "What if we need the assets in the future?" You explain that in order for these arrangements to reduce estate tax, the gifts and sales need to be completed transactions. The transferred assets will be owned by the trustees of the trusts and may be used for the benefit of the clients' children and other descendants. If, however, the trustee also could make distributions to the clients, tax risks arise.

You also explain that under most state laws, your clients' creditors could reach the assets in the trust to the maximum extent that the trustees retain discretion to make distributions back to the clients.[4] As a result, if the trustee was given discretion to make distributions to the clients, your clients could "relegate" their creditors to the assets in the trust by merely not paying those creditors. This is a sufficient retention of economic access to prevent any gifts from being complete and to tax the trust assets at the clients' deaths.[5]

You add that some states have passed laws that many attorneys think will protect against estate taxation in this situation. The IRS, however, has not taken a position, so a tax risk exists. Your clients look somewhat puzzled. They repeat the question, "What if we need the assets in the future?" You decide to just give them the bottom-line response, "We cannot design the trust to allow the trustee discretion to distribute assets back to you because of the risk that those assets will be included in your gross estate and taxed at your death." Your clients thank you for the consultation and promise to call for a follow-up appointment. They do not call back. When your office tries to contract them, they evade the scheduling of another appointment.

DAPT TAX HISTORY

All too often, the inability to both save estate taxes and at the same time allow distributions to the clients if needed in the future ends the discussion of effective estate planning approaches. Prior to 1997, almost all states had statutory or case law that provided that it was against public policy to protect the assets of a DAPT from the settlor's creditors.

In 1997, however, the door was pushed ajar for combining these two seemingly antithetical goals when Alaska enacted a statute expressly providing that creditors of the settlor could not reach assets that the settlor had transferred to a self-settled discretionary spendthrift trust.[6] Later in 1997, Delaware followed with a somewhat similar statute. Since then, other states have enacted DAPT statutes. As of the present, there are now 11 states (12 if Colorado is included, although its laws are uncertain in that regard) that allow the formation of DAPTs.[7]

The Alaska DAPT statute was initially conceived to try to repatriate some of the billions of dollars that had been transferred offshore in order to seek asset protection. It quickly became apparent to practitioners, however, that transfer tax minimization planning was a concomitant benefit of this new type of statute. [8]

In a state that has not enacted a DAPT statute, a settlor's creditors can reach the maximum amount that the trustee could distribute to the settlor. Consequently, the settlor can "run up" debts, and the settlor's creditors can reach the trust assets to satisfy these obligations. Another way of looking at the situation is that the settlor, indirectly, has retained the economic access to the trust assets through incurring debts. In the jargon used in by the IRS, the settlor can "relegate" his creditors to the trust assets. [9]

The above-described indirect retention of economic access to the trust assets prevents the settlor's transfer to the trust from being a completed gift for gift tax purposes. Reg. 25.2511-2(b) provides that a gift is complete if the donor "has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another...." This test may not be satisfied by DAPTs governed by the laws of, and administered in, non-DAPT states. Such indirect retention of economic access would result in the inclusion of the trust assets in the settlor's estate under Sections 2036 and 2038. Section 2036 would probably apply because the settlor has retained the enjoyment of, and income from, the property by the settlor's ability to incur debt that the settlor's creditors may satisfy from trust assets. Section 2038 would apply because the ability to relegate creditors to the trust assets allows the settlor to revoke the transfer of assets to the trust. [10]

When the state-law policy that allows creditors to reach the assets of a self-settled discretionary spendthrift trust is reversed, the settlor has parted with dominion and control over the trust assets, so the gift is complete. The IRS has agreed with this conclusion. In Ltr. Rul. 9837007, an Alaska resident proposed to create a self-settled trust for the benefit of herself and her descendants. The trustee was given discretion to distribute income and principal to a class of beneficiaries which included the settlor. The Service held:

"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 Service stopped there, however, stating: "We are 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."

Compelling arguments exist that when the state law described above is reversed, the trust assets should not be included in the settlor's gross estate and taxed at death. Section 2038 should not apply because, as of the date of the settlor's death, the settlor does not have the power to revoke the trust by relegating creditors to the trust assets. The remaining estate tax issue is whether, under Section 2036(a)(1), the settlor has retained enjoyment of, or the right to income from, the trust assets.

Initially, the plain language of the statute, which requires "retention," does not seem to apply to a settlor-beneficiary who may receive distributions only pursuant to the absolute discretion of an independent trustee. Several authorities support the conclusion that "retention" within the meaning of Section 2036(a)(1) does not exist with respect to the

rights of a discretionary settlor-beneficiary. [11] Commentators have reached the same conclusion. [12]

Rev. Rul. 2004-64, 2004-2 CB 7, provides strong inferential support for the conclusion that the assets of a well-planned DAPT will not be includable in the settlor's estate. That Ruling involved irrevocable inter vivos trusts that were grantor trusts for income tax purposes. The relevant issue was whether the trustee's discretionary power to reimburse the settlor for income tax that the settlor paid on the trust income constituted "the possession or enjoyment of, or the right to the income from," the trust assets so that the value of those assets would be included in the settlor's estate under Section 2036(a)(1). The Service ruled that the trustee's discretion to reimburse the settlor would not alone cause inclusion of the trust assets in the settlor's estate. [13]

There is a close analogy between the Ruling's conclusion and the question of whether the assets of a typical DAPT are subject to estate tax inclusion. In a typical DAPT, an independent trustee has absolute discretion concerning whether to make distributions to the settlor. Finding "retention" under the existing language of Section 2036, based only on the settlor's status as a discretionary beneficiary, is a significant stretch. In a similar situation involving questionable coverage by Section 2036 of joint purchases of property, Treasury found a statutory change necessary. [14]

With this tax history in mind, we now focus on the important new DAPT tax authority, Ltr. Rul. 200944002.

THE NEW LETTER RULING

In a ruling released 12 years after the Alaska DAPT statute went into effect, and after 12 states had enacted such statutes, the IRS finally considered the estate tax issue. Once again, the ruling involved an Alaska DAPT. [15]

In Ltr. Rul. 200944002, the trustee was given authority, in the trustee's sole and absolute discretion, to distribute income and principal to one or more members of the class consisting of the settlor, the settlor's spouse, and the settlor's descendants. The Alaska Trust Company was nominated as the Investment Trustee, the Independent Trustee, and the Administrative Trustee. An independent attorney was nominated both as the trust protector, who had the power to change trustees, and as the trust Selector, who had the power to remove the settlor as the beneficiary of the trust.

On the death of the settlor and the settlor's spouse, the remaining trust principal would be divided into shares for the settlor's descendants, per stirpes, in a perpetual trust plan. At the time when there are no living descendants of the settlor, the remaining trust assets would be distributed to one or more charitable organizations chosen by the trustee.

The trust instrument expressly stated that the following persons may not be a trustee of any trusts created under the trust instrument: the settlor, the settlor's spouse or former spouse, any beneficiary, any spouse or former spouse of a beneficiary, or anyone who is related or subordinate to the settlor within the meaning of Section 672(c). The trust instrument expressly provided that the trustee "shall not pay" the settlor or the settlor's executors any income or principal of the trust in discharge of the settlor's income tax liability.

In the ruling request submission, the taxpayer requested rulings on the following issues:

> (1) A completed taxable gift occurred when the settlor made a contribution to the trust.
> (2) No portion of the trust's assets would be included in the settlor's gross estate.

A thorough discussion of the authorities supporting both ruling requests was provided in the submission. [16] In the submission's conclusion, the authors stated: "Based on the Statement and Analysis of the Law, as applied to the facts discussed herein, a completed taxable gift will occur when the grantor makes a contribution to the Trust. Further, no portion of the Trust's assets will be included in the grantor's gross estate."

Completed gift. The Service found little difficulty in repeating its favorable ruling that the transfer to the trust was a completed gift: "In this case, Grantor has retained no power to revest beneficial title or reserved any interest to name new beneficiaries or change the interests of the beneficiaries. Consequently, we conclude that Grantor's transfer of $X to trust will be a completed gift of $X."

Gross estate. The Service then turned to the settlor's request for a ruling that no portion of the trust assets would be includable in the settlor's gross estate. The IRS first discussed Rev. Rul. 2004-64 which, as noted above, considered situations in which the trustee reimburses the grantor for taxes paid by the grantor because of grantor trust status. Ltr. Rul. 200944002 states:

"Rev. Rul. 2004-64 ... considers situations in which the trustee reimburses the grantor for taxes paid by the grantor attributable to the inclusion of all or part of the trust's income in the grantor's income. In Rev. Rul. 2004-64, a grantor created an irrevocable inter vivos trust for the benefit of the grantor's descendants. The grantor retained sufficient powers with respect to the trust so that the grantor is treated as the owner of the trust under subpart E, part I, subchapter J, of chapter 1 of the Code. When the grantor of a trust, who is treated as the owner of the trust under subpart E, pays the income tax attributable to the inclusion of the trust's income in the grantor's taxable income, the grantor is not treated as making a gift of the amount of the tax to the trust beneficiaries. If, pursuant to the trust's governing instrument or applicable local law, the grantor had to be reimbursed by the trust for the income tax payable by the grantor that was attributable to the trust's income, the full value of the trust's assets would be includible in the grantor's gross estate under §2036. If, however, the trust's governing instrument or applicable local law gave the trustee the discretion to reimburse the grantor for that portion of the grantor's income tax liability, the existence of that discretion, by itself, whether or not exercised, would not cause the value of the trust's assets to be includible in the grantor's gross estate. However, such discretion combined with other facts (including but not limited to: an understanding or pre-existing arrangement between grantor and the trustee regarding the trustee's exercise of this discretion; a power retained by Grantor to remove the trustee and name grantor as successor trustee; or applicable local law subjecting the trust assets to the claims of grantor's creditors) may cause inclusion of Trust's assets in grantor's gross estate for federal estate tax purposes.

"In this case, under the terms of Article Twelfth, paragraph D, the trustee is prohibited from paying Grantor or Grantor's executors any income or principal of Trust in discharge of Grantor's income tax liability. Although, Rev. Rul. 2004-64 does not consider this situation, it is clear from the analysis, that because the trustee is prohibited from reimbursing Grantor for taxes Grantor paid, that Grantor has not retained a reimbursement right that would cause Trust corpus to be includible in Grantor's gross estate under §2036. See Rev. Rul. 2004-64."

This analysis seems unnecessary, as the trust itself prohibited the trustee from reimbursing the settlor for income taxes paid with respect to the trust's assets. But then, in one additional sentence the IRS finally takes an express position concerning DAPTs and the estate tax, and the position is favorable: "In addition, 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."

The Service's discussion of Rev. Rul. 2004-64 appears to provide the foundation for the most important part of the letter ruling, which is that the trustee's absolute discretion to make distributions to a class of beneficiaries which includes the settlor does not, by itself, cause the trust corpus to be included in the settlor's gross estate under Section 2036.

The IRS concludes by stating: "We are specifically not ruling on whether Trustee's discretion to distribute income and principal of Trust to Grantor combined with other facts (such as, but not limited to, an understanding or pre-existing 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."

This letter ruling is extremely important for estate transfer tax minimization planning.[17] For the first time in 12 years, the IRS has agreed that a DAPT may be used to exclude assets from the settlor's gross estate, even though the settlor is a discretionary beneficiary of the trust. Many more clients will be willing to use estate planning techniques to minimize estate taxes at their deaths knowing that, if a future emergency arises, the trust's assets can be distributed back to the clients. In the introductory example in this article, annual exclusion gifts, applicable credit gifts, grantor retained annuity trusts, and sales to grantor trusts, among other techniques, may be used to transfer assets to irrevocable trusts that include the settlor as a discretionary beneficiary.

THE NECESSARY ASSET PROTECTION FOUNDATION

As discussed above, asset protection is the foundation not only for protecting assets from creditors but also for obtaining transfer tax benefits. The analyses for a completed gift under Reg. 25.2511-2(b) and for avoidance of the "string" provisions under Sections 2036 and 2038 focus on whether the settlor has retained controls through the ability to relegate the settlor's creditors to the assets of the trust. Therefore, the first asset protection foundation question is whether state law prohibits the settlor's creditors from reaching the assets in the trust even though the settlor is a discretionary beneficiary. This question is discussed below in the section entitled "Who Can Take Advantage of This Planning?" Prior to that discussion, however, several other foundation issues need to be reviewed.

Fraudulent Transfers

Even if state law prohibits creditors from reaching the assets in the trust, if the transfer was fraudulent the creditor will be able to set the transfer aside and reach the trust's assets.

Almost all of the DAPT states have express statutory exceptions that exclude fraudulent transfers from their spendthrift trust protection.[18] All states but Alaska have adopted the Uniform Fraudulent Transfer Act. Alaska has a narrower fraudulent transfer statutory provision. Under both the Uniform Fraudulent Transfer Act and federal bankruptcy law, a transfer to a DAPT may be set aside if "the debtor made the transfer with actual intent to

hinder, delay, or defraud" a creditor. [19] Most fraudulent transfer situations can be avoided by proper planning.

Avoidance of fraudulent transfers is often a central issue when a client requests planning for purely asset protection purposes. In the best case, the client focusing on transfer tax minimization will not have existing creditor issues that could result in a fraudulent transfer. An estate tax planner, however, could inadvertently overlook the client's overall financial situation and produce planning that results in a fraudulent transfer which a creditor could set aside. In such a situation, even if the creditor does not pursue the fraudulent transfer, the IRS could argue that the asset protection foundation was lacking. [20]

Estate planners, like asset protection planners, should carefully follow due diligence procedures to determine whether existing liabilities and foreseeable future liabilities are present. [21] If such liabilities have not been adequately provided for, the settlor's contemplated transfer to the DAPT may be found to be fraudulent. Hence, either the DAPT should not be formed, or its formation should be postponed until the liabilities have been satisfied or secured.

Improper Implementation

The second type of asset protection foundation issue relates to improper implementation. This is a catch-all category that commentators also have labeled as the alter-ego theory or sham theory. [22] This is the same type of general concept that can be used to attack the validity of any entity—whether trust, limited partnership, LLC, or corporation. In essence, the theory is that, after formation of the entity, the key parties failed to respect the separate existence of the entity and the basic requirements for proper implementation of the entity.

Trustee independence. Perhaps the most vulnerable area for a DAPT involves the independence of the trustee who has authority to make distributions to the beneficiaries, including the settlor. This is an area where a settlor who was reluctant to give up control may take actions that render the trust vulnerable. A typical DAPT will provide that the independent trustee has absolute discretion to make distributions to a class of beneficiaries that includes the settlor, the settlor's spouse, and the settlor's descendants.

No agreement. To preserve the independence of the trustee, there must not be any agreement between the independent trustee and the settlor regarding distributions. The existence of such an agreement would allow the settlor's creditors to reach the trust assets because the settlor would have a right to the distribution of the assets. The tax result would be inclusion of the assets in the settlor's gross estate. [23]

Such an agreement could be written, oral, or implied through a pattern of distributions or a close relationship. [24] Such a relationship would include being a close relative, close friend, or employee. Therefore, it is important to choose a trustee who will minimize the risk that an implied agreement will be found. [25] If a collusive relationship exists, the trust is a "sham," and is the settlor's "alter ego." [26]

The transfer of too large a proportion of the settlor's assets to a DAPT invites a court to find that an agreement exists between the settlor and the trustee. The rationale for this finding is that a settlor would not give away assets that the settlor knew with some certainty he or she would need in the future, unless the settlor also knew that he or she could get the assets back. Good planning would involve an analysis, perhaps by the

client's accountant, of the assets the client should retain to pay for anticipated living expenses. [27]

Statutory requirements. Another type of improper implementation would be to fail to comply with the requirements for applicability of DAPT state law. All DAPT states require that the DAPT trust have a resident trustee, who is a resident individual or trust company or bank of the DAPT state. Most states require that this trustee maintain records and prepare or arrange for the preparation of income tax returns, on an exclusive or non-exclusive basis, and must participate in trust administration. [28] Some trust assets need to be located in the DAPT state. [29] Failure to comply with these requirements will result in that state's DAPT law not being applied to the trust.

Formalities. Another area where a DAPT would be vulnerable to the "alter ego" theory is if the settlor or members of the settlor's family continued to manage trust assets that had been transferred to the DAPT. If such management is desired, the assets should first be contributed to a limited partnership or LLC. The clients may desire that they, or family members, be the general partners or managers. The clients then transfer the limited partnership interest or the LLC non-managerial interest to the DAPT. In this way, clients or their family members may retain the ability to manage assets without violating the actual property ownership of the assets and without being trustees.

WHO CAN TAKE ADVANTAGE OF DAPT TAX PLANNING?

Clearly, if your client is a resident of a DAPT state which has a sound DAPT statute (see the discussion below), then that client can take advantage of the DAPT transfer tax minimization planning discussed above. What if your client resides in a DAPT state but desires to use the law of another DAPT state? What if your client used to reside in a DAPT state but now has moved and resides in a state that does not have a DAPT statute? What if your client has always resided in a non-DAPT state but wishes to take advantage of a DAPT state law? This nonresident client may or may not have some contacts with the DAPT state.

DAPT Resident Using Another DAPT Law

First, consider the resident of a DAPT state using that state's or another DAPT state's statute. Almost all DAPT state statutes (except Nevada) provide one or more exceptions to this spendthrift trust protection.

Some of these exceptions apply only if the creditor situation existed at the time of the transfer of the assets to the DAPT, for example, child support payments due at the date of transfer or tort claims occurring before or on the date of the transfer. These creditors can be ascertained at the time of planning for the DAPT and, if they exist, the claims should be satisfied before the DAPT is formed.

Other DAPT statute exceptions, however, may occur after the DAPT is formed, for example, alimony and property division claims. Utah's statute goes farthest and excepts claims resulting from judicial, arbitration, mediation, or administrative proceedings within three years after the trust was created, as well as public assistance claims, tax claims, and violations of certain written representations or agreements.

The issue here is whether these statutory exceptions to DAPT asset protection are significant enough to support an IRS argument that the settlor has retained the ability to relegate the settlor's creditors to the assets of the trust to a degree sufficient to apply

Sections 2036 and 2038. Utah's statute appears to go too far. The other DAPT state statutes that apply to events occurring after the formation of the DAPT fall into a gray area. [30] If the client in such a state wants to be conservative, then perhaps the best approach is to use a DAPT statute from another DAPT state. [31]

Some commentators have argued that Rev. Rul. 2004-64 and the authority it relies on seem to indicate that if any creditor of the grantor may reach the trust assets, then the trust assets will be included in the grantor's gross estate. They point out that under Reg. 20.2036-1(b), inclusion occurs "to the extent that the use, possession, right to the income or other enjoyment [from the trust] is to be applied toward the discharge of a legal obligation of the decedent or otherwise for his pecuniary benefit." They argue that it would be more prudent to use Alaska's or Nevada's statutes, which do not provide any significant statutory exceptions. These commentators conclude, "when and if the law of another state is clarified so its creditors' rights provisions will not cause estate tax inclusion, the trust could be relocated (as occurred in Rev. Rul. 76-103) and the governing law changed to such other state." [32]

Nonresident of DAPT State

If the client does not reside in a DAPT state at the time of formation of the trust, then the third asset protection foundation issue must be considered.

Example: A nonresident of a DAPT state establishes a DAPT. Subsequently, the settlor is sued in either state or federal court by a creditor. The court may be located in the settlor's state or in the DAPT state. Assume that the court obtains jurisdiction over the trustee of the DAPT. The creditor will argue that the court should choose the spendthrift trust law of the settlor's state of residence, rather than the law of the DAPT state. If the court opts to apply the law of the state of residence—which does not provide asset protection for DAPTs—to the question of whether the settlor's creditors can attach the trust assets, the creditor will be allowed to reach the trust assets. The resulting tax consequence will be that the trust assets will be included in the settlor's gross estate.

Thus, the issue is which state's spendthrift trust rules apply—those of the DAPT state, or the rules of the settlor's state? A subsidiary issue is whether this question is one of administration or validity of the trust. [33]

This issue is analyzed below based on the principles in the Restatement (Second) of Conflict of Laws. It is assumed here that such principles would be applied by a court sitting in the DAPT state or in the settlor's state of residence. Nevertheless, each state's conflict of laws rules should be researched to determine if they differ from those of the Restatement.

Administration. If the question of whether the assets of the trust may be attached by the settlor's creditors is one of administration of the trust, the settlor's choice of DAPT law in the trust instrument controls. The Restatement provides in section 273(b) that whether the interest of a beneficiary of a trust of movables is assignable by him and can be reached by his creditors is determined (in the case of an inter vivos trust) by the local law of the state, if any, in which the settlor has manifested an intention that the trust is to be administered.

Validity. If the question is one of validity of the trust, section 270 of the Restatement again provides that the settlor's choice of DAPT law in the trust instrument will prevail if the DAPT state "has a substantial relation to the trust and that the application of its law

does not violate a strong public policy of the state with which, as to the matter at issue, the trust has its most significant relationship under the principles stated in §6."

Generally, the DAPT state will satisfy the requirement of having a substantial relation to the trust. A factual determination will have to be made, however, as to which state has the most significant relationship to the trust. The settlor's contacts with the state may well influence this determination.

Strong public policy. The settlor's state of residence may allow one or more other approaches that are essentially the same as a self-settled spendthrift trust. Consider state statutes that provide creditor protection for "self-settled" techniques such as IRAs, life insurance, annuities, homesteads, tenancies by the entirety, Section 529 plans, and similar planning approaches. If the state of residence allows some or all of such self-settled approaches, a significant argument can be made that the state does not have a "strong public policy" against self-settled asset protection planning. [34]

In his treatise, Professor Scott states that differences in spendthrift trust laws are not enough to establish a "strong public policy" that would justify disregarding the law of the state of administration chosen by the settlor. [35] Professor Siegel, generally analyzing the public policy exception in the conflict of laws area, states the following:

"The latter possibility makes the ‘public policy’ issue germane here, but on the American scene, where the federal constitution imposes minimum standards of fairness on all of the states, uncommon is the appearance of a law so offensive to a forum's ‘public policy’ that the forum will refuse to apply it....

"Before a foreign claim or law is rejected on the ground that it violates forum ‘public policy,’ the forum feeling about the matter must be shown to be a deep one, to touch on something the forum deems to involve moral values rather than just a different way of doing things....

"One may ask how much room there is today for an American court to refuse a sister-state claim on the ground that it offends forum public policy. The answer is: little." [36]

Rule of validation. Professor Siegel states that "[c]ourts favor a rule of validation, meaning that if of two related states the trust is valid under the law of one but invalid under the law of the other, the one that validates is chosen." [37]

Enactment of numerous statutes. The fact that now 11 (perhaps 12) states have effective DAPT statutes also should influence this "strong public policy" subject. Initially, in 1997, Alaska and Delaware were the only states with thorough DAPT statutes. (The Missouri and Colorado statutes preceded Alaska's, but were terse and not as useful for planning purposes.) This law appeared exotic and subject to the argument that the vast majority of states disapprove of this policy. Many other states have followed suit, however. As more and more states enact DAPT statutes, it becomes more difficult to argue that the DAPT policy is extraordinary and therefore violates the strong public policy of non-DAPT states.

Speculative retention. The above analysis establishes that there will be significant uncertainty concerning whether a court will apply the law of the nonresident settlor's domicile rather than the DAPT law selected in the trust instrument. Commentators recently have argued that "[S]ection 2036(a)(1) does not apply where the grantor retains something that is merely speculative and/or contingent." [38] That is, the fact that a court

may choose to apply the law of the settlor's domicile and allow a creditor to reach the assets of the trust is not "retention" under Section 2036(a)(1). [39]

Summary. So far, there are no published cases or rulings involving the choice of law issue for domestic DAPTs, whether in the asset protection or transfer tax minimization areas.

In regard to asset protection, the most likely forum for such cases will be federal bankruptcy court. There are numerous bankruptcy cases that apply a choice of law designated in the trust instrument. [40] While it is encouraging for the proponents of DAPTs that the bankruptcy courts are generally willing to apply the law of the state where the trust was created, these decisions still must be relied on with caution. The cases do not involve self-settled trusts and in none of the cases, except one, is it clear that the choice of law was a seriously contested issue. [41]

Nevertheless, there are several cases involving foreign asset protection trusts where bankruptcy courts have chosen the law of the settlor's state of residence rather than that of the foreign jurisdiction that was designated in the trust instrument. These cases have involved bad facts and fraudulent transfers. [42]

The authorities discussed above favor application of the choice of law specified by the settlor in the trust instrument. Certain of the Restatement principles are fact-dependent. The DAPT state must have a substantial relation to the trust. Moreover, a determination must be made as to the state with which, regarding the matter at issue, the trust has its most significant relationship. These factual determinations may well be affected by the settlor's contacts with the DAPT state and the manner in which the trust has been implemented.

Advising Clients

In view of the above choice of law rules, consider the various client situations outlined above:

- A client who is a resident of a DAPT state that has a statute with significant creditor protection exceptions (and therefore tax issues) should be able to instead form a DAPT in another DAPT state. The IRS would have a very difficult time arguing that there was a "strong public policy" in the client's state of domicile against DAPT statutes when that state itself has enacted such a statute.
- What about a client who used to live in a DAPT state but now has retired to a non-DAPT state? Here, the client probably has retained significant contacts with a DAPT state. They may include assets located there, a second residence, relatives, and of course a history of having resided in that state. The client may frequently return to the DAPT state. All of these contacts may well persuade a court that the DAPT state is the state which, as to the matter at issue, the trust has its most significant relationship pursuant to sections 6 and 270 of the Restatement (Second) of Conflict of Laws.
- What about the client who has never resided in a DAPT state? Can this client form a trust using the DAPT law of another state? This is the most interesting and currently ambiguous planning situation. The asset protection foundation for a nonresident settlor using a DAPT is not absolute. If a court concludes that the question is one of administration of the trust, the settlor's choice of DAPT law in the trust instrument will control. If the court concludes that the question is one of validity of the trust, the court will need to decide whether the application of the DAPT's state law will violate a "strong public policy" of the settlor's state of

residence. The authorities and arguments discussed above, other "self-settled" techniques in the state of domicile, and the facts relating to the settlor's contacts with the DAPT state and the implementation of the trust, all may well influence the resolution of this "strong public policy" issue.

The planner working with the nonresident client may well be able to influence the success of the application of the DAPT state law. First, consider an analysis of the law of the client's state of domicile. Review the strength of the domiciliary state statutory or case law that provides that a creditor can reach the assets in a self-settled trust to the extent that the trustee has discretion to distribute those assets to the settlor. Review whether that domiciliary state provides creditor protection for one or more other types of self-settled techniques. Encourage the settlor to establish contacts with the DAPT state. These would include locating assets there, executing all trust documents and transfers there, retaining a trustee, attorney, and accountant there, and visiting the state periodically. The combination of these facts may well influence the forum or other reviewer of the soundness of the DAPT planning.

Nonresident clients considering the use of a DAPT for transfer tax minimization should do a downside analysis. The main downside risk would appear to be that the settlor has lost the opportunity to do some different planning. Going back to our introductory hypothetical, would it have been better for our clients to have proceeded with DAPT planning, because it would allow the trustee to distribute assets back to them in the future if the need should arise, than for the clients to have left our office and not proceeded with any significant planning at all? For the nonresident client, this may be the central question.

CONCLUSION

Estate planners are constantly urging clients to transfer assets to an irrevocable trust and use techniques such as grantor retained annuity trusts and sales to grantor trusts in order to exclude assets from the federal gross estate at the client's death. Clients, while eager to accomplish this goal, ask the rational question, "what if I need the assets in the future?" DAPTs provide satisfaction of both of these goals.

Ltr. Rul. 200944002 is the Service's first ruling directly approving the use of DAPTs for estate tax minimization. This ruling involved the most conservative of facts situations: a resident of a DAPT state using that state's DAPT law. The choice of law authorities establish that residents of one DAPT state should be able to use the law of another DAPT state. Future rulings and perhaps court decisions will establish whether nonresidents of a DAPT state can take advantage of a DAPT state's law. The law of the nonresident settlor's state of residence, the contacts that the nonresident establishes with the DAPT state, and the manner of implementation of the trust may all influence the success of this type of transfer tax planning for a nonresident settlor.

Practice Notes

- Estate planners, like asset protection planners, should carefully follow due diligence procedures to determine whether existing liabilities and foreseeable future liabilities are present. If such liabilities have not been adequately provided for, the settlor's contemplated transfer to the DAPT may be found to be fraudulent. Hence, either the DAPT should not be formed, or its formation should be postponed until the liabilities have been satisfied or secured.

- The transfer of too large a proportion of the settlor's assets to a DAPT invites a court to find that an agreement exists between the settlor and the trustee. The rationale for this finding is that a settlor would not give away assets that the settlor knew with some certainty he or she would need in the future, unless the settlor also knew that he or she could get the assets back. Good planning would involve an analysis, perhaps by the client's accountant, of the assets the client should retain to pay for anticipated living expenses.

[1]

Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-16, 6/7/01). In 2009, the applicable credit protected $3.5 million of assets, and the tax rate was 45%. Legislation introduced during 2009 would have extended this amount and rate, and other legislation would have increased the credit and reduced the rate. None of those proposals were passed in 2009; hence, the repeal in 2010. See generally Blattmachr, Gans, Zaritsky, and Zeydel, "The Impossible Has Happened: No Federal Estate Tax, No GST Tax, and Carryover Basis for 2010," 112 JTAX 68 (February 2010).

[2]

The gift tax was not repealed. If new legislation unifies the gift and estate taxes, this amount may change.

[3]

Proposals have been made to eliminate certain valuation discounts. See, e.g., H.R. 436, Certain Estate Tax Relief Act of 2009, introduced 1/9/09.

[4]

See, e.g., Restatement (Third) of Trusts, §58 and §60, comment f.

[5]

See, e.g., Rev. Rul. 76-103, 1976-1 CB 293, and Rev. Rul. 77-378, 1977-2 CB 347.

[6]

Alaska Stat. section 34.40.110.

[7]

A chart that describes these 12 statutes can be found in Shaftel, "A Comparison of the Various State Domestic Asset Protection Trust Statutes," 35 Estate Planning No. 3 (March 2008), page 3; Shaftel, "Variations in State Domestic Asset Protection Statutes Compared," 35 Estate Planning No. 4 (April 2008), page 14; and 34 ACTEC J. 293 (2009). This chart was reviewed and edited by the following ACTEC fellows: David G. Shaftel (Alaska), Marc A. Chorney (Colorado), Richard G. Bacon (Delaware), Larry P. Katzenstein (Missouri), Layne T. Rushforth (Nevada), William Zorn (New Hampshire), Richard B. Kells (Oklahoma), Mary Louise Kennedy (Rhode Island), John H. Raforth (South Dakota), Bryan Howard (Tennessee), Thomas Christensen, Jr. (Utah), and Robert H. Leonard (Wyoming).

[8]

Some DAPTs are formed only for asset protection purposes; transfer tax minimization is not a goal. If the funds transferred are substantial, then deliberate techniques are used to make the transfers "incomplete" for federal gift tax purposes. These sole-purpose asset protection DAPTs are not the subject of this article.

[9]

Rev. Rul. 76-103, *supra* note 5.

[10]

Id.; Rev. Rul. 77-378, *supra* note 5; Paolozzi, 23 TC 182 (1954), *acq.*

[11]

These authorities include: Ltr. Rul. 9332006; Ltr. Rul. 8037116; Estate of German, 55 AFTR 2d 85-1577, 7 Cl Ct 641 (Cls. Ct., 1985); *cf.* Estate of Uhl, 50 AFTR 1746, 241 F2d 867 (CA-7, 1957). See also Estate of Wells, TC Memo 1981-574, PH TCM ¶81574 . These and other authorities are discussed in Rothschild, Blattmachr, Gans, and Blattmachr, "IRS

Rules Self-Settled Alaska Trust Will Not Be in Grantor's Estate," 37 Estate Planning No. 1 (January 2010), page 3.

[12]

Practical Drafting (U.S. Trust Co. of N.Y.), page 4891 (July 1997); Dodge, 50-5th T.M. (BNA), *Transfers With Retained Interests and Powers,* p. A-23; Stephens, Maxfield, Lind, and Calfee, *Federal Estate and Gift Taxation,* Seventh Edition (Warren, Gorham & Lamont, 1996), ¶4.08[4][c], page 4-154; but see Pennell, 2 *Estate Planning* §7.3.4.2 (Aspen, 2003).

[13]

The IRS qualified its holding by stating that applicable local law subjecting the trust assets to the claims of creditors may cause inclusion of the assets in the grantor's gross estate. See generally Shop Talk, "New Ruling on Consequences When Grantor Is Taxed on Trust's Income," 101 JTAX 253 (October 2004).

[14]

Section 2702(c)(2), enacted in 1990. With respect to the joint purchase situation, Professor Pennell concluded: "It was sufficiently unclear whether I.R.C. §2036(a)(1) would apply to such a case that I.R.C. §2702(c)(2) specifically addresses this form of transaction." Pennell, *supra* note 12, §7.3.4.1, page 7.334.

[15]

The Alaska Trust Company, trustee of the trust, has shared with the author additional facts relating to this ruling.

[16]

See the authorities cited in note 11, *supra,* and the other authorities discussed in the Rothschild, et al., article cited in that note.

[17]

A letter ruling is not precedent and only applies to the applicant. Nevertheless, letter rulings are indicative of the Service's position.

[18]

Alaska Stat. section 34.40.110(b)(1); Del. Code Ann. tit. 12, sections 3572(a) and (b); Mo. Rev. Stat. sections 456.5-505, 3(l); N.H. Rev. Stat. Ann. section 564-D:9; Okla. Stat. tit. 31, section 17; R.I. Gen. Laws sections 18-9.2-4(a) and (b); S. Dak. Codified Laws section 55-16-9; Tenn. Code Ann. section 35-16-104(a); Utah Code Ann. section 25-6-14(1)(c)(ii); Wyo. Stat. Ann. section 4-10-514. The Colorado and Nevada statutes do not explicitly refer to fraudulent transfers. Both states, however, have enacted the Uniform Fraudulent Transfer Act.

[19]

UFTA section 4(a); 11 U.S.C. section 548(e).

[20]

Even when no known liabilities exist, the possibility that a future creditor will challenge a transfer to a DAPT as fraudulent cannot be completely eliminated. Under all of the DAPT statutes except Nevada's, a transfer to a DAPT may be challenged as fraudulent within four years of the transfer (two years in Nevada). Each statute has a discovery exception which allows a creditor to assert a fraudulent transfer attack after the above periods. The discovery exception is one year (six months in Nevada) after the transfer was or reasonably could have been discovered by the claimant. Alaska has narrowed its discovery exception considerably. A thorough discussion of the limitations periods and discovery exceptions may be found in Shaftel and Bundy, "Domestic Asset Protection Trusts Created by Nonresident Settlors," 32 Estate Planning No. 4 (April 2005), page 17. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), however, has had the effect of extending the limitations period to ten years for fraudulent transfers to DAPTs. This was the result of a compromise after attempts were made to disallow DAPTS entirely. The effect of the BAPCPA on DAPTs is analyzed in Shaftel and Bundy, "Impact of New Bankruptcy Provision on Domestic Asset Protection Trusts," 32 Estate Planning No. 7 (July 2005), page 28.

[21]

Due diligence procedures are fully discussed in Shaftel, Special Session materials for "Everything You Always Wanted to Know About Domestic Asset Protection Trusts But Could Never Find Out," 38 U. Miami Heckerling Inst. on Est. Plan. (2004), pages 1-C-31 through 1-C-33; and in Shaftel, "Domestic Asset Protection Trusts: Key Issues and Answers," 30 ACTEC J. 27-28 (Summer 2004).

[22]

Osborne, "Asset Protection and Jurisdiction Selection: Clearing Up Your Situs Headaches," 33 U. Miami Heckerling Inst. on Est. Plan. (1999), page 14-20.

[23]

See Reg. 20.2036-1(a), which finds "retention" under Section 2036 if such an agreement exists.

[24]

Cases involving Section 2036 and an implied understanding of grantor access are discussed in Boxx, "Gray's Ghost—A Conversation About the Onshore Trust," 85 Iowa L. Rev. 1195 (1999), pages 1244-1251.

[25]

The concerns about an implied agreement between the settlor and a trustee also apply with respect to settlors and trust protectors and trust advisors. Some DAPT statutes expressly recognize the use of trust protectors who have powers to change trustees and make certain modifications to the trust agreement. See Alaska Stat. section 13.36.370. Similarly, some DAPT statutes authorize the use of a trust advisor who may advise the trustee but whose advice is not binding on the trustee. See Alaska Stat. section 13.36.370.

[26]

See Danforth, "Rethinking the Law of Creditors' Rights in Trusts," 53 Hastings L.J. 287 (2002), page 302.

[27]

Some DAPT statutes attempt to nullify the risk of an implied agreement by stating that an agreement or understanding, express or implied, between the settlor and the trustee that attempts to grant or permit the retention of greater rights or authority than is stated in the trust instrument is void. See Alaska Stat. section 34.40.110(j); Del. Code tit. 12, section 3571.

[28]

Alaska Stat. section 13.36.035(c); Del. Code Ann. tit. 12, section 3570(9)(b); Nev. Rev. Stat. section 166.015, 1(d); N.H. Rev. Stat. Ann. section 564-D:3; R.I. Gen. Laws section 18-9.2.2(9)(ii); S. Dak. Codified Laws section 55-16-3; Tenn. Code Ann. section 35-16-102(12)(B); Wyo. Stat. Ann. section 4-10-103(a)(xxxv).

[29]

Alaska Stat. section 13.36.035(c)(1); Del. Code Ann. tit. 12, section 3570(8)(b); Nev. Rev. Stat. section 166.015(b); N.H. Rev. Stat. Ann. section 564-D:33; Okla. Stat. tit. 31, section 11,2; R.I. Gen. Laws section 18-9.2-2(8)(ii); S. Dak. Codified Laws section 55-16-3; Tenn. Code Ann. section 35-16-102(12)(B); Utah Code Ann. section 25-6-14; Wyo. Stat. Ann. section 4-10-103(a)(xxxv)(B)(I).

[30]

Readers who desire to compare the exceptions to spendthrift trust protection in the various DAPT state statutes may refer to the comparison chart cited in note 7, *supra.*

[31]

One other variation of state DAPT statutes does not qualify for transfer tax minimization. Oklahoma's "Family Wealth Preservation Act" allows a variation of a DAPT that is a revocable trust. As a result, if a settlor desires access to assets in the trust, the settlor merely revokes the trust to the extent of the desired distribution. The retention of this revocation power will result in the trust's assets being included in the settlor's gross estate under Section 2038.

[32]

See Rothschild, et al., *supra* note 11.

[33]

This choice of law subject, as well as issues relating to jurisdiction, full faith and credit, and the contract clause, are thoroughly covered in a three-article series by Shaftel and Bundy, including the two cited in note 20, *supra,* along with "Domestic Asset Protection Trusts and the Bankruptcy Challenge," 32 Estate Planning No. 5 (May 2005), page 14.

[34]

See Danforth, *supra* note 26, pages 325 and 333-343 (2002).

[35]

Scott and Fratcher, *The Law of Trusts,* §626, page 414.

[36]

Siegel, *Conflicts in a Nutshell,* 2d ed. (West Pub. Co., 1994), §57. Interesting examples of this choice of law issue are provided in Hutchison v. Ross, 187 NE 65 (1933), and Intercontinental Hotels Corp. (Puerto Rico) v. Golden, 203 NE2d 210 (1964).

[37]

Siegel, *supra* note 36, §96. The Restatement (Second) of Conflict of Laws, §6, comment g, reaffirms that "the courts seek to apply a law that will sustain the validity of a trust of moveables (see §§269-270)." Also see §270 of the Restatement, comment d.

[38]

Rothschild, et al., *supra* note 11.

[39]

See the authorities discussed in the Rothschild, et al., article, *supra* note 11.

[40]

A thorough discussion of these cases may be found in the May 2005 Shaftel and Bundy article, *supra* note 33.

[41]

Id.

[42]

Id., pages 22-24.