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## **Asset Protection Trusts - The Tax Angle**

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### ***Tax Law Bulletin***

#### **1. Traditional Antipathy of Domestic Law to "Asset Protection".**

The protection of children and other family members who are potential "spendthrifts" from their own financial indiscretions has always been considered a legitimate element of estate planning in the United States. By contrast, "self-settled spendthrift trusts" have been widely regarded as an anathema in the United States, partly in deference to the equitable concept that a person of means should not be permitted to escape his debts through the device of a trust and partly by reason of a strong and well-organized creditors' rights lobby which has doubtless influenced the development of statutory law in respect of trusts. The distinguishing feature of a "self-settled spendthrift trust" is that the settlor under the terms of the trust deed is a permissible beneficiary eligible to receive income or principal distributions in the exercise of the discretion of an independent trustee. The traditional legal response to such trusts in the U.S., as a matter of state law, has been that creditors of the settlor may reach the assets of such trusts to the full extent of trustee discretion exercisable in favor of the settlor.

#### **2. Modern Foreign Facilitation of "Asset Protection".**

In the mid-80's the Isle of Man pioneered an effort to reintroduce foreign trusts to the U.S. market for purposes other than tax avoidance. It argued that its law, unlike that in the U.S., would not sanction creditor attacks on self-settled spendthrift trusts. This marked the birth of the so-called "asset protection trust". At about the same time the State of Missouri adopted a statute providing limited creditor protection for self-settled spendthrift trusts, but such action went unnoticed by the legal profession at large. The Isle of Man's promotion of foreign asset protection trusts rapidly attracted the attention of numerous other jurisdictions traditionally known as "tax havens". As a result, several such jurisdictions moved rapidly circa 1990 to repeal ancient laws derived from the Statute of Elizabeth 1571 which had inhibited the effectiveness of self-settled spendthrift trusts.

#### **3. The Federal Tax Law Response.**

Although it remains debatable how widespread the use of offshore asset protection trusts

(so-called "OAPT's") had become by the mid-90's, Congress and Treasury were convinced that asset protection schemes were fast becoming a hand maiden to large scale tax evasion; and as a result tax laws enacted effective August 20, 1996 both clarified the definition of a "foreign" trust and introduced comprehensive new information reporting requirements in respect of off shore trusts. See IRC §§ 7701(a)(30) and 6048. The new reporting requirements were accompanied by draconian new penalty provisions for noncompliance. See IRC § 6677.

#### **4. Emergence of Domestic Asset Protection Law.**

No sooner had Congress acted in an effort to curtail OAPT's than enterprising professionals and promoters encouraged first Alaska and then Delaware to enact statutes in 1997 which preclude creditor attack on self-settled trusts (with some modest exceptions in the case of Delaware law). The actions of Alaska and Delaware were emulated by Nevada in October 1999, and Texas has introduced but not enacted legislation facilitating self-settled spendthrift trusts. In addition, the states of Missouri (as previously noted) and also Colorado have legislation arguably enabling a self-settled spendthrift trust in certain circumstances. Unlike the OAPT's which have been widely regarded as mechanisms for the morally repugnant but marginally lawful avoidance of creditors claims, domestic asset protection trusts (so-called "DAPT's") have variously been presented as either (a) legitimate responses to tort law run amok or (b) evidence of "trust law's race to the bottom" in the United States or (c) an intriguing but untested new tool for estate planners which demands careful consideration but also invites certain risks. The focus of the balance of this bulletin is on the tax planning issues generated by the self-settled spendthrift trusts.

#### **5. How Creditors' Rights May Determine Gift Completion.**

In many instances considerable tax advantage may attach to rendering a living gift "complete" at the moment it is made either because (a) the donor's status is about to change from non-domiciled alien to domiciled alien or (b) the donor's gift, if complete, would be sheltered by the unified credit and, if of a "present interest", would be eligible for the annual exclusion or (c) notwithstanding the imposition of a gift tax, donor anticipates the possibility of radical appreciation in the value of the subject matter of the donation. These considerations are arguably tempered by the possibility of a phased repeal of the federal gift and estate tax, but, if as many anticipate, a substantially larger unified credit is enacted in lieu of phased repeal, the emphasis upon the importance of the "completion" of a living gift might become even more important in future years.

The Internal Revenue Service and the courts have uniformly and very correctly taken the position that the legal access of creditors of a trust settlor to trust assets by reason of provisions in the trust deed permitting discretionary distributions in favor of the settlor (i.e., a self-settled spendthrift trust) may render the gift incomplete because the settlor has reserved de facto backdoor access to his assets through his creditors. It matters not that the settlor is wholly solvent and that the possibility of third party creditor attack is entirely hypothetical. See Rev. Rul. 76-103, 1976-1 C.B. 293; *Outwin v. Comm.*, 76 T.C. 153 (1981); *Estate of Paxton*, 86 T.C. 785 (1986). If the settlor funds a self-settled spendthrift trust in a jurisdiction which does not grant third party creditor access to trust assets solely on the basis that the settlor is a permissible discretionary beneficiary of his

trust, the intriguing questions arise (a) has the settlor of such a trust made a "completed gift" at the moment of funding and (b) if a gift to such a trust is complete for Federal gift tax purposes, is it also complete for Federal estate tax purposes?

There is general agreement corroborated by two private letter rulings which may not be cited as precedent that a donation to a self-settled spendthrift trust enjoying legislative protection from third party creditor claims is a completed gift. See Private Letter Ruling 9332006 (8/20/92) [IRS accepted applicant's representation "...that under the laws of country X, neither a beneficiary nor any creditor of any beneficiary, including the Settlers, may compel the trustee to distribute the Trust's assets to or for their benefit at any time during the trust term ..." and concluded for this and other reasons that Outwin and Paxton did not apply and that the transfers to the trusts were completed gifts for both gift and estate tax purposes at the moment of trust funding]; Private Letter Ruling 9837007 (6/10/98) [commentators have widely identified the subject state law as that of Alaska; IRS accepted that "... because the trust contained certain language specified in the statute, a creditor of the grantor will be precluded from satisfying claims out of the grantor's interests in the trust..." and for this and other reasons concluded that the proposed transfer by donor would be a completed gift for Federal gift tax purposes but expressly did not rule on whether the assets held under the trust would be includable in donor's gross estate for Federal estate tax purposes].

#### **6. The Unresolved Question: Is A Completed Living Gift To A Self-Settled Spendthrift Trust Also Complete For Federal Estate Tax Purposes?**

There has been a tendency on the part of some planners and promoters of OAPT's and DAPT's to assume that if a transfer is complete for gift tax purposes, a fortiori it will be complete for estate tax purposes. While such assumption is not wholly unreasonable, it is fraught with risk.

Significantly the recent private letter ruling dealing with the effects of a transfer in trust subject to Alaska law contained an express refusal to rule on whether the assets held under the Alaska trust agreement at the time of the donor's death would be includable in the donor's estate for Federal estate tax purposes. Both the person who drafted the ruling request and the IRS personnel responsible for framing the letter response have spoken freely to commentators, and there appears general consensus among the commentators that (a) the IRS refusal to rule on the estate tax consequences of the Alaska trust was not intended to draw a purposeful distinction between OAPT's and DAPT's [note that in the case of earlier Letter Ruling 9332006 which involved a foreign trust the Service did rule favorably on the estate tax issue], (b) there is a heightened degree of IRS scrutiny of, and concern for, the role of APT's (both offshore and domestic) in estate planning and (c) the principal practical reason the Service eschewed a ruling on the estate tax consequence was the need to "wait and see" whether evidence of any implied agreement between donor and trustee would emerge from the facts during the course of trust administration and mandate a determination of inclusion for estate tax purposes.

Predicting the estate tax consequences of a completed living gift to a self-settled spendthrift trust is an uncertain exercise for several reasons including:

Policy uncertainty exists whether, where the donor is domiciled in a state whose

public policy opposes self-settled spendthrift trusts but the trust is accepted and administered in a sister state whose law sanctions such trusts, the IRS will be able to challenge (or will in fact challenge) the application of the law of the place of trust administration [recent Bankruptcy Court decisions, including, e.g., *In re B.V. Brooks*, 32 Bankr. Ct. Dec. 23, 1998 WL 35018 (Bankr. D. Conn.), dealing with abusive offshore asset protection trusts have refused to recognize the applicability of foreign law to putatively foreign trusts on public policy grounds].

It is a well-established precept of transfer tax law that, if an implied agreement is shown by the facts to exist between settlor and trustee that notwithstanding that the trust is discretionary on its face particular benefits will flow to the settlor, settlor has a retained interest justifying inclusion in his estate without regard to third party creditor rights.

Given the current practice of some settlors of claiming deep discounts for assets gifted in trust during their lifetimes, the Service will have an extra incentive in the case of the self-settled spendthrift trust to argue for estate tax inclusion in order to revalue assets.

Although most federal courts have shown a disinclination in the transfer tax context to consider policy reasons why pro-debtor statutory provisions of a borrowed jurisdiction's law should not apply, the Tax Court has shown greater inclination to engage in such policy analysis [a factor which heightens the possibility of estate tax inclusion].

Settlors relying on the law of states such as Delaware, which enact asset protection legislation but carve out meaningful exceptions for certain creditors such as spouses and dependent children, risk the argument that their asset protection law of choice is not sufficiently robust to overcome the retained interest argument premised upon back door creditor access.

## **7. Assessing the Future of Domestic Asset Protection.**

Dozens of lengthy and heavily footnoted articles have been authored by academics who are enraged by, and opposed to the viability of, asset protection trusts, both foreign and domestic; an equal number of shorter less cerebral articles have been produced by practitioners eager to describe and promote the potential benefits of APT's. A very balanced current article on the subject is one authored by an individual with substantial experience as a practicing attorney who is currently on a leave of absence from his law firm as visiting tax professor at the University of Florida. See Eason, *Home From The Islands: Domestic Asset Protection Trust Alternatives Impact Traditional Estate And Gift Tax Planning Considerations*, 52 Fla. L. Rev. 41 (January 2000) which concludes with the intriguing observation: "Just as Alaska, Delaware and Nevada noticed and reacted to the burgeoning offshore trust industry, more U.S. states are likely to take note of the domestic opportunities now available to settlors. How such states respond will have a significant bearing upon transfer tax planning dynamics. For example, consider the likely topics of discussion at upcoming estate and gift planning seminars if DAPT's were to go the route of LLC's - receiving a clear IRS blessing of general applicability and suddenly becoming the norm in all U.S. jurisdictions."

*This article should not be construed as legal advice or opinion, since legal opinions are only given to clients in response to inquiries involving specific facts.*