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Home From the Islands: Domestic Asset Protection Trust Alternatives Impact Traditional Estate and Gift Tax Planning Considerations

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HOME FROM THE ISLANDS: DOMESTIC ASSET PROTECTION TRUST ALTERNATIVES IMPACT TRADITIONAL ESTATE AND GIFT TAX PLANNING CONSIDERATIONS

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I. INTRODUCTION

An increasingly litigious U.S. social environment has contributed to an increased occurrence of U.S. citizens sheltering significant portions of their wealth in offshore asset protection trusts. Simply stated, an offshore asset protection trust ("OAPT" or "offshore APT") is a trust which is established under foreign trust laws by a U.S. citizen, typically managed by a foreign trustee, and "designed to lawfully remove assets from the settlor's balance sheet without creating any adverse federal tax consequences or requiring the settlor to lose all control over [such] assets."[1] More generally, the term "asset protection trust" (or "APT") can be viewed as a trust, the assets of which are, as to a particular beneficiary, immune from the claims of that beneficiary's creditors.

The increasingly common utilization of such OAPTs by wealthy U.S. citizens has led to more widespread recognition of such entities by the U.S. financial, legal, and government communities. Indeed, with a conservatively estimated $2,000,000,000,000 (that's TRILLION) in assets held in offshore trusts,[2] there can be little doubt that inroads into this

1. Michael H. Azad, *Asset Protection Planning with Offshore Trusts and Offshore Corporations*, 12 TAX NOTES INT'L 500 (1996).

2. WALTER H. DIAMOND & DOROTHY B. DIAMOND, 1 INTERNATIONAL TRUST LAWS AND ANALYSIS at FRW-1 (1999). Other estimates place the figure as high as six-trillion dollars. *See* Eric Henzy, *Offshore and "Other" Shore Asset Protection Trusts*, 32 VAND. J. TRANSNAT'L L. 739, 740 n.3 (1999) (citing estimate by Britain's Home Secretary as reported in pound currency at David Leigh, *Billions Hidden Offshore; Jersey Faces Tax Clampdown*, GUARDIAN (LONDON), Sept. 26, 1998, at 1); *see also* Debra Baker, *Island Castaway*, A.B.A. J., Oct. 1998, at 54 (placing estimate

lucrative market will be pursued with increasing aggressiveness by *domestic* enterprises. Somewhat surprising, however, is the directness with which the states of Alaska and Delaware are openly vying to share in the spoils inherent in the movement and management of such wealth. Those two domestic jurisdictions have, over the last few years, enacted trust legislation with the expressly stated objective of attracting to their respective states the wealth management business that has in recent years begun moving offshore at an alarming pace.[3] In order to counter the success offshore jurisdictions have enjoyed in attracting clients seeking asset protection coupled with wealth management, Alaska and Delaware by competitive necessity have included in their respective statutes provisions granting to trust settlors a degree of explicit asset protection benefits previously unavailable in any United States jurisdiction. Dispelling any notions that the Alaska and Delaware legislation can be ignored as an isolated and passing trend, legislation similar to that of Alaska and Delaware became effective in Nevada on October 1, 1999, and a mirror image of the Alaska legislation was proposed but not acted upon in the 1999 session of the Texas House.[4]

The primary focus of this article is upon the extent to which a trust settlor's retention of an interest in a domestic asset protection trust

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as high as five-trillion dollars).

3. As to the pace at which funds have been moving from the United States to offshore jurisdictions, see Part IV, *infra*. Demonstrative of the objectives underlying the new domestic legislation, the legislative history behind the recent changes to Delaware's trust legislation is explicit in noting that "[t]hese new [statutory] features should make Delaware a more attractive jurisdiction for establishing trusts that are protected, under certain defined conditions, from claims of a settlor's creditors" and that certain of those statutory features were specifically "intended to facilitate the repatriation of existing offshore trusts to Delaware." H.B. No. 747, 139th Sess. (Del. 1988) *printed in* 71 DEL. LAWS 343 (1998). The history of the Alaska statutory changes reveals similar motivations. *See* H.B. 101 (Alaska 1997) (statement of Rep. Al Veezy, R-North Pole) ("Alaska has the opportunity to establish itself as a major financial market for the U.S. and even the world.").

4. 1999 NEV. STAT. §§ 166.040-.060 (Assembly Bill No. 469); H.B. 1553 (Tex. 1999) (introduced Feb. 17, 1999). Because the Nevada legislation appears to be an adaption of the more detailed Alaska and Delaware statutes, and given that the Texas legislation has not yet become law, the analytical focus of this article will be upon the provisions of the Alaska and Delaware legislation. Occasional reference will, however, be made to certain variations in the Nevada legislation. It should also be noted that pertinent legislation in Missouri and Colorado should be examined for its self-settled asset protective features, although such legislation is of debatable impact and in any event predates the domestic asset protection trust movement initiated by Alaska's 1997 adoption of comprehensive asset protection trust legislation. *See* Mo. Rev. Stat. § 456.080 (1992) (providing limited creditor protection for self-settled spendthrift trusts, dating back to 1983); Colo. Rev. Stat. §§ 38.10-.111 (1997) (providing protection for self-settled spendthrift trusts as against future creditors). The Colorado statute, which apparently dates back to 1861, is discussed in Gideon Rothschild et al., *Self-Settled Spendthrift Trusts: Should a Few Bad Apples Spoil the Bunch?*, 32 VAND. J. TRANSNAT'L L. 763, 774 (1999).

("DAPT" or "domestic APT") created by that settlor affects traditional transfer tax planning dynamics. Specifically, it has long been held to be against public policy for a trust settlor to place property in trust while naming himself or herself as a beneficiary thereof, such that the settlor/beneficiary can still enjoy the trust property while preventing the settlor/beneficiary's creditors from reaching such property. Likewise, it has long been a tenant of the federal transfer tax regime that property given away will nevertheless be subject to inclusion in the transferor's gross estate at death if the transferor retains enjoyment of such property until death. Any other transfer tax result has been described as an impermissible "have your cake and eat it too" scheme.[5] By virtue of the recent domestic trust legislation, however, these long-standing United States principles have been challenged in a manner more direct and definite than that implicated solely by trends in offshore jurisdictions. The resulting concept—that a transferor's retention of a beneficial domestic trust interest might not result in the inclusion of such trust property in the transferor's gross estate at death—has a profound impact upon the traditional approach to estate and gift tax planning.

Presented first is a general examination of the recent movement towards using the trust entity as an asset protection vehicle for the benefit and protection of the individual establishing and funding the trust. This movement raises both tax policy and social policy questions which, while not resolved herein, are presented as background to understanding the non-traditional estate and gift tax planning analysis which these new domestic statutes implicate. The specific Alaska and Delaware trust legislation is explained, as are questions concerning the effectiveness of that legislation in delivering its purported asset protection benefits. Although such

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5. *See, e.g.*, Joseph M. Dodge, *Redoing the Estate and Gift Taxes Along Easy-to-Value Lines*, 43 TAX L. REV. 241, 271 (1988) (noting in context of distributions from a trust not included in the settlor's gross estate at death: "It might be supposed that the settlor in such a case has the cake while her estate eats it too. . . ."); Elena Marty-Nelson, *Taxing Offshore Asset Protection Trusts: Icing on the Cake?*, 15 VA. TAX REV. 399, 400 n.1 (1996) (noting prior articles titled by reference to this analogy, and expressing desire to "abstain from all mention of cakes and confections in future articles"). *See also* RICHARD B. STEPHENS ET AL., FEDERAL ESTATE AND GIFT TAXATION § 4.08 (7th ed. 1997), wherein the interrelationship of Internal Revenue Code §§ 2033 and 2036(a)(1) is described as follows:

> [A]s far as . . . section [2033] is concerned, an individual could gratuitously transfer property in trust, ridding himself of legal title, and yet retain the right to income from the property for life without having his estate suffer an estate tax liability with respect to the property upon his death. This, of course, would be a real cake-and-eat-it scheme; but it is frustrated by Section 2036(a)(1).

For an explanation of how this "having your cake and eating it too" scenario might arise today, see *infra* note 135, and accompanying text.

questions cannot at this point be definitively answered since the asset protection provisions of the domestic legislation remain untested in any reported decision, such questions are nevertheless considered as a necessary adjunct to the primary focus of this article—specifically, the extent to which a DAPT created under and (at least purportedly) governed by Delaware, Alaska, or Nevada law should be considered as an enhancement to a traditional estate and gift tax-planning strategy.

II. THE (PERCEIVED) NEED FOR ASSET PROTECTION

It is easy to perceive the basis for the liability concerns which have led many wealthy individuals to seek to remove at least a portion of their assets from the reach of potential claimants. A cursory review of any national newspaper or news magazine is likely to reveal, on a frequently recurring basis, a story (or two, or several) about:

- someone being sued in an action where the potential liability stakes are high, not to mention the very real cost of litigation that will be endured even if no judgment against the alleged wrongdoer is entered;

- someone recovering a substantial judgment under what most people would have, at least ten or fifteen years ago, deemed a ridiculous cause of action;[6]

- someone experiencing a drastic downturn in their fortunes, both circumstantial and monetary, leaving them much less financially prepared for the future than anticipated; or

- someone, in anticipation of one of the foregoing events, taking steps to lessen their potential exposure to financial devastation which could result from such events.[7]

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6. Although potential judgments might not ultimately qualify as substantial (only time will tell), heretofore unimaginable lawsuits are proliferating. As one such example, National Public Radio reported recently that a school teacher has filed suit against a student whom the teacher caught smoking in the bathroom, for alleged physical injuries suffered by the teacher as a direct result of the student's smoking (this was not, apparently, a case of student-against-teacher violence in the schools). *See NPR Morning Edition* (NPR radio broadcast, Mar. 15, 1999). The suit included a claim for "unspecified punitive damages." *Id.*

7. As to the latter point, asset protection in its most rudimentary form was a surprising footnote to the recent $107 million judgment entered against the proprietors of the notorious "abortion hit-list" Web site. In the reports of the judgment, the liable proprietors were noted as stating that they had already undertaken asset transfers so as to render themselves "judgment-proof." Sam Howe Verhovek, *Creators of Anti-Abortion Web Site Told to Pay Millions*, N.Y. TIMES, Feb. 3, 1999 at A9.

Indeed, some of the popular literature posits the case for asset protection by focusing on the litigation boom in the United States, generating enthusiasm in introductory pages by reciting the range of people subject to unexpected litigation, and the large verdicts juries have become prone to award.[8] One practitioner's more professional recitation of some of the domestic threats to wealth which are driving the growth of asset protection as a legal practice area includes:

- Risks associated with contractual guarantees (or other potential failings), or liability attributable to a business venture or associate therein;

- The escalating cost of liability insurance premiums, coupled with the narrowing scope of coverage and ongoing questions about stability within the insurance industry;

- Growing regulatory liability, such as in the field of land ownership and environmental concerns;

- Divorce claims and concerns arising incident to divorce, which cannot always be addressed adequately through premarital agreements (e.g., "the evolution of inter-spousal tort liability claims");

- A desire to ensure that intended beneficiaries receive wealth at death, notwithstanding forced heirship, former spouses or other claimants; and

- New theories of liability attributable to a particularly creative plaintiffs' bar, as well as the growing measure of damages for injuries that are often purely subjective in nature.[9]

It is difficult to refute the validity of the foregoing concerns, and it has always been the province of wise counsel to be proactive in limiting the liability exposure of clients. Today that concept, for good or ill, is evolving

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8. *See, e.g.*, ROBERT F. KLUEGER, A GUIDE TO ASSET PROTECTION—HOW TO KEEP WHAT'S LEGALLY YOURS 12-13 (1997) (reciting stories of a priest sued for "negligent care" by a suicidal parishioner, among others); MARK WARDA, SIMPLE WAYS TO PROTECT YOURSELF FROM LAWSUITS 8-9 (1997) (noting jury awards of up to $569 million, including a $986,000 jury award to a lady "who 'lost her psychic powers' after a CAT scan").

9. *See* Leslie C. Giordani, *Asset Protection: Domestic and Foreign Planning Alternatives*, 33 S. FED. TAX. INST., Oct. 1998, at W1-2.

to include advice not only as to the client's activities and business structures, but also advice as to the manner in which the client holds (or more sheepishly, enjoys) his or her assets. On the other hand, it is merely the legal and financial environment and the *degree* of asset protection planning which has changed—asset protection has always been a central element of estate planning.[10] It is products of this changed environment, however, which have given rise to new opportunities for the estate planner and clients.

III. SELF-SETTLED SPENDTHRIFT TRUSTS

Before going into further detail, it is first prudent to examine generally the basic legal doctrines under which a trust might purportedly provide some degree of asset protection to its beneficiaries. Most commonly, a trust settlor may attempt to shield a beneficiary's interests from the claims of the beneficiary's creditors by:

- Creating a "discretionary trust" which provides that distributions to the beneficiary are subject to the unrestricted discretion of the trustee, as to which discretion the trustee cannot be compelled to exercise in favor of the beneficiary, the beneficiary's creditors, or anyone else; or

- Creating a "spendthrift trust," the terms of which incorporate specific "spendthrift" language expressly prohibiting the voluntary and involuntary alienation (by creditor attachment or otherwise) of the beneficiary's trust interest.[11]

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10. *See, e.g.*, Jonathan Blattmachr et al., *Trusts and Estates: Alaska's Revision of Its Trust Act, Which Sets Out to Permit Trusts to Preserve Assets and Reduce Taxes, May Have Implications for Trust Planning Nationwide*, NAT'L L.J., June 6, 1997, at B5 ("Two common goals in estate planning are estate tax reduction and protection of assets from claims of creditors."); Joseph A. Field, *Asset Protection Planning—A Look at Some of the Drawbacks—The Case Against*, *in* DIAMOND & DIAMOND, *supra* note 2, ¶ 2001, at INT 201-07 (1999) ("[T]his type of [asset protection] planning is really nothing more or less than fine tuning of 'plain vanilla' trust structuring, which practitioners have undertaken for centuries in one form or another."); Giordani, *supra* note 9, at W4 ("[E]state planning by its very nature has always implicitly embodied asset protection.").

11. A "discretionary trust" is a trust under the terms of which "it is provided that the trustees shall pay to or apply for a beneficiary only so much of the income and principal or either as the trustee in his uncontrolled discretion shall see fit. . . ." Estate of Paxton v. Commissioner, 86 T.C. 785, 804 n.12 (1986) (quoting 1 RESTATEMENT (SECOND) OF TRUSTS § 155(1) (1959)). "A spendthrift provision provides that the interest of the beneficiary is inalienable and that creditors cannot reach the interest in satisfaction of their claims." *Id.* at 817 n.31. *See, e.g.*, DEL. CODE ANN. tit. 12, § 3570(9)(c) (Supp. 1998) (qualified disposition is to be made under trust instrument which

Of course, it is possible for a settlor to create a trust which contains multiple "protective" features, such as a discretionary trust which includes spendthrift language. With respect to both discretionary trusts and spendthrift trusts, however, it has been the rule since Elizabethan times that such a trust will not be recognized to prevent the *settlor's* creditors from reaching any interest in trust property *to the extent* such interest has been retained by the settlor.[12] Two of the more straightforward and often cited statements of this "widely accepted legal principle" as adopted in the United States were quoted by the Tax Court in *Estate of Paxton v. Commissioner*,[13] as follows:

> Where a person creates for his own benefit a . . . discretionary trust, his transferee or creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit.[14]

> If a settlor creates a trust for his own benefit and inserts a spendthrift clause, it is void as far as then existing or future creditors are concerned, and they can reach his interest under the trust.[15]

The rationale for this principle is grounded in public policy concerns. "It is against public policy to permit a man to tie up his own property in such a way that he can still enjoy it but can prevent his creditors from reaching

"[p]rovides that the interest of the transferor or other beneficiary . . . may not be transferred, assigned, pledged or mortgaged, whether voluntarily or involuntarily . . . .").

A "self-settled" trust is a trust created and (at least in part) funded by someone who is included as a beneficiary of the trust. *See* Sattin v. Brooks (*In re* Brooks), 217 B.R. 98, 102 (Bankr. D. Conn. 1998). The court in *Brooks* adopts this simple definition by reference to the RESTATEMENT (SECOND) OF TRUSTS, Section 156(2). *See id.*; 1 RESTATEMENT (SECOND) OF TRUSTS, § 156(2) (1959). Both types of trust—the discretionary and the expressly spendthrift trust—when including the settlor as a beneficiary are referred to herein as a "self-settled spendthrift trust" for ease of reference. For a further exposition on the mechanisms and terminology with respect to creditor-protected trusts interests, see Elena Marty-Nelson, *Offshore Asset Protection Trusts: Having Your Cake and Eating It Too*, 47 RUTGERS L. REV. 11, 16-28 (1994).

12. *See* IIA AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, THE LAW OF TRUSTS § 156 (4th ed. 1987) [hereinafter IIA SCOTT & FRATCHER] (tracing origin of this rule to Statute of King Henry VII passed in 1487, which voided conveyances in trust for the use of the transferor). Also relevant in this regard is the English Statute of Elizabeth, which voids a transfer lacking consideration and intended to delay, hinder or defraud creditors. 13 Eliz. ch. 5 (1571). *See* A. JAMES CASNER & JEFFREY N. PENNELL, 1 ESTATE PLANNING ¶ 4.1.4 nn. 31-32. (6th ed. 1998).

13. 86 T.C. 785 (1986).

14. *Id.* at 814 (quoting 1 RESTATEMENT (SECOND) OF TRUSTS § 156(2) (1959)).

15. *Id.* at 815 n.26 (quoting GEORGE GLEASON BOGERT & GEORGE TAYLOR BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 223 (rev. 2d ed. 1992)).

it."[16]

Likewise, it has long been a tenant of the federal transfer tax regime that retained enjoyment of transferred property carries with it taxability of that property in the transferor's estate at death.[17] In the trust context, a settlor's retention of even a discretionary interest in property transferred by such settlor to a trust results in inclusion of the trust property in the settlor's taxable estate at death, to the extent that under applicable state law the settlor's creditors can reach such trust property by virtue of the doctrines discussed above which invalidate self-settled spendthrift trusts.[18] Traditionally, creditors had the right in virtually all states to access trust property in satisfaction of a claim against a settlor/beneficiary,[19] such that the resulting estate tax consequences were both obvious and negative. In light of the new Delaware, Alaska, and Nevada statutes, however, it is now time to reconsider the validity of these long-standing United States principles. Before examining how the new domestic statutes purport to change the general rule invalidating self-settled spendthrift trusts—thereby correspondingly impacting the federal estate and gift tax consequences attendant such trusts—it is relevant to consider further the background against which such domestic legislation has been enacted.

IV. THE MOVEMENT OF WEALTH OFFSHORE

Among the more significant changes to the asset protection and estate planning environments over the last decade or so has been the growth in the movement of funds into trusts created under the laws of non-U.S. jurisdictions.[20] Many such offshore jurisdictions allow settlors to retain significant enjoyment of funds which, by virtue of being held in a trust created under the offshore jurisdiction's trust laws, are purportedly subject

16. IIA SCOTT & FRATCHER, *supra* note 12, § 167.

17. *See* I.R.C. §§ 2036-2038 (CCH 1998). The Internal Revenue Code of 1986, as amended and set forth in Title 26 of the United States Code, is herein cited as "I.R.C.," with reference to the relevant Code section.

18. *See* I.R.C. §§ 2036-2038 (providing generally that property over which decedent retained an interest, reversion or power will be includable in decedent's gross estate at death). IRS Revenue Ruling 76-103 discusses the doctrine that creditors' rights in trust property may be deemed an interest retained by the trust settlor. *See* Rev. Rul. 76-103, 1976-1 C.B. 293 (stating that creditors' rights are akin to settlors' powers to terminate a trust); *Paxton*, 86 T.C. at 814 ("Retention of the right to use the trust as a form of security for his indebtedness [by virtue of creditors' rights to trust property] left [the settlor] with a significant interest in the property . . . that is sufficient to require [the settlor's] transfers to the trusts to be included in his gross estate under section 2036(a)(1).").

19. *See, e.g.*, Marty-Nelson, *supra* note 11, at 29, 38 n.113 (noting this "universally-accepted exception" to spendthrift trust protection, and listing 18 states which have codified the rule).

20. The terms "offshore" or "foreign" are variously used in this article to refer to non-U.S. jurisdictions, and references to the movement of funds offshore refer generally to funds moving out of the U.S. financial system, at least directly, and into the financial system of a foreign jurisdiction.

to that jurisdiction's debtor-friendly laws.[21] The most glaring contrast between the laws of such offshore jurisdictions and the traditional trust laws of the several United States is grounded in the provisions of foreign trust law which expressly permit the settlor of the trust to also be a "creditor-protected" beneficiary of such trust, meaning that under the foreign jurisdiction's laws the settlor's creditors may neither compel a trust distribution nor attach the settlor's trust interest in satisfaction of the settlor's debts.[22]

In addition and relative to the utilization of more traditional domestic asset protection structures, proponents of OAPTs tout the benefits of "going offshore" as including legal hurdles imposed by the foreign trust jurisdiction which render it more difficult for a creditor to set aside a transfer of property to a trust created under that jurisdiction's laws.[23] For example, practical and legal hurdles that a potential claimant may face in collecting on a U.S. judgment where the debtor's "former" assets are held via an OAPT of which the debtor is the settlor-beneficiary include:

- Shorter limitations periods for challenging the original transfer to the trust as fraudulent;
- A more limited class of creditors entitled to assert the fraudulent conveyance issue at all, such as limiting such class to only those creditors having a bona fide claim against the debtor-settlor at the time the transfer to the trust was made;
- Requirements that the entire matter be retried *de novo* in the foreign jurisdiction's courts, sometimes with creditor representation only via a local attorney; and
- Requirements that the plaintiff make a significant deposit

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21. *See generally* PETER SPERO, ASSET PROTECTION: LEGAL PLANNING AND STRATEGIES ¶ 6 (1994) (discussing self-settled trusts); Giordani, *supra* note 9, at W13-18 (discussing offshore trusts).

22. *See* SPERO, *supra* note 21, ¶ 6.08(4).

23. *See* Barry S. Engel, *Asset Protection Planning Through the Foreign Situs Asset Protection Trust—The Case For, in* DIAMOND & DIAMOND, *supra* note 2, ¶ 1004, at INT 102-03 [hereinafter Engel, *in* DIAMOND]; Azad, *supra* note 1, at 502; *see also* Douglas J. Blattmachr & Jonathan G. Blattmachr, *A New Direction in Estate Planning: North To Alaska*, TR. & EST., Sept. 1997, at 48, 53-54 (contrasting foreign and domestic trusts). More traditional domestic asset protection strategies might include, for example, titling property in the name of a spouse who is not engaged in a risky business or profession, holding property via a limited partnership or other entity as to which a creditor may attach only the debtor's interest in the entity without the ability to compel any distribution from the entity, or establishing a spendthrift trust for third parties. *See* Giordani, *supra* note 9, at W4-W6.

before proceeding with the lawsuit.[24]

Significant also are U.S. creditors' psychological disincentives to pursuing a claim against a settlor-debtor, such as physical distance from the assets sought and the burden of collecting through a foreign legal system against a foreign trustee.[25]

Thus, with no remotely comparable asset protection vehicle available in any domestic jurisdiction prior to the adoption in 1997 of the Alaska spendthrift trust legislation, the movement of funds offshore is not surprising. This movement of funds "offshore"—used here to mean out of the U.S. financial system, at least directly, and into the financial system of a foreign jurisdiction—should not be dismissed without scrutiny as a mere unavoidable consequence of the modern global economy.[26]

Indeed, concern over this movement of funds offshore (and more specifically into offshore trusts) sparked significant new foreign trust legislation in 1996 and 1997.[27] This new legislation was aimed at settlors, beneficiaries and trustees of offshore trusts, and increased substantially the reporting requirements to be observed when funds are transferred to offshore trusts, imposing "harsh penalties" for compliance failure.[28] Reports on the impetus behind this legislation clearly reflect the growth of this type of offshore planning, as well as some of the tax policy issues thereby raised:

> The foreign trust proposal is an attempt by the [Clinton] administration to tax the income from hundreds of billions of dollars of U.S.-source capital being stashed by U.S. taxpayers in foreign trusts in tax havens around the world. In releasing

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24. *See* Azad, *supra* note 1, at 502; Blattmachr & Blattmachr, *supra* note 23, at 48, 53-54 (contrasting foreign and domestic trusts); Engel, *in* DIAMOND, *supra* note 23, at INT 102-03; Giordani, *supra* note 9, at W14; Richard W. Hompesch, II et al., *Does the New Alaska Trust Act Provide an Alternative to the Foreign Trust?*, J. OF ASSET PROTECTION, July-Aug. 1997, at 9.

25. *See* Engel *in* DIAMOND, *supra* note 23, ¶ 1004.

26. Outside the more limited context of OAPT fund transfers, no less than three Congressional Committees, the Federal Reserve, the GAO, the Comptroller of the Currency, the Treasury Department and the U.S. Attorney's Office are investigating more general issues relating to currency movement, money laundering and the "regulatory nightmare" that has become private banking on a global scale. S.C. Gwynne, *Just Hide Me the Money*, TIME, Dec. 14, 1998 at 46.

27. *See generally General Explanation of Tax Legislation Enacted in the 104th Congress Before the Joint Committee on Taxation*, 104th Cong. (Comm. Print 1996); Robert F. Hudson, Jr., *Loch Ness Monster or Komodo Dragons—Actual and Unexpected Results of the Foreign Trust Legislation of 1996/1997*, 32 U. MIAMI SCH. OF L. PHILIP E. HECKERLING INST. ON EST. PLAN. ¶ 1900 (Tina Hestrom Portundo ed., 1998); Carlyn S. McCaffrey, *Fencing in Tax-Travelers—the New Foreign Trust Rules*, 31 U. MIAMI SCH. OF L. PHILIP E. HECKERLING INST. ON EST. PLAN. ¶ 1700 (Tina Hestrom Portundo ed., 1997).

28. McCaffrey, *supra* note 27, ¶ 1700.

> the proposal, Treasury cited press reports that nearly $650 billion has been transferred from the United States to just three jurisdictions: the Cayman Islands, the Bahamas, and Luxembourg.
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> According to the administration, the U.S. market for asset protection trusts is "exploding," but is believed to be fueled less by a desire to evade taxes than to protect assets from creditors. Once the assets are overseas, however, taxpayers soon realize that income generated in the overseas accounts—and protected by strict bank secrecy laws—can accumulate without the IRS's knowledge and, therefore, is not reported.[29]

Notwithstanding the recent imposition of increased reporting requirements and noncompliance penalties, this offshore trust area remains of significant concern to the federal government. For example, the Tax Division of the Attorney General's Office recently announced its plans to "direct increased resources" towards fighting areas of international tax fraud, including specifically offshore trust arrangements.[30] The Internal Revenue Service ("IRS") is also concerned that funds, once moved offshore, simply disappear from the U.S. tax system. Informal conversations with IRS attorney-personnel having responsibility in this field indicate that the IRS views offshore trust arrangements as "the tax haven of the next millennium."[31] Indeed, press reports indicate that the IRS

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29. *Administration Proposes Anti Abuse Rules for Foreign Trusts, Expatriation*, 66 TAX NOTES 915 (1995). Noted in the article is that in 1990, the last year for which figures were available at the time of the Clinton proposals, U.S. persons (who were subject to information reporting requirements that were rarely complied with) "reported the creation of 133 foreign trusts with total assets of about $273 million . . . [but] reported annual income of only $3 million." *Id.* This would seem to support at least one of the following arguments: that such offshore trusts are merely avenues to committing tax fraud; that one would have to be a fool to invest $273 million with a foreign trustee who can earn a meager $3 million on the assets; or that tax exempt investments are even more en vogue than offshore trust arrangements.

30. Tom Herman, *The Justice Department Targets Global Tax Fraud and Cybercrime*, WALL ST. J., Aug. 12, 1998, at A1.

31. Although specific and very informative conversations were had with IRS personnel significantly connected with the crafting and enforcement of IRS policy in this area, the most well-placed of such personnel specifically requested that no direct reference be made to his identity. Interestingly, inquiries concerning past successes and future plans with respect to perceived abuses in this area were met with "no comment." However, it does appear that the IRS's primary concern is to impress upon U.S. persons that offshore trusts should be viewed as "tax neutral," in recognition of the fact that U.S. citizens and residents are subject to U.S. taxation on their worldwide income, not just income from U.S. sources or locations. *See, e.g.*, I.R.C. § 61(a) (1998) ("[G]ross income means all income from whatever source derived. . . ."); Treas. Reg. § 20.2033-1(a) (as amended in 1963) ("The gross estate of a decedent who was a citizen or resident of the United States at the time of his death includes . . . the value of all property . . . wherever situated, beneficially owned by the decedent at the time of his death."). Thus, it would appear that the IRS efforts in this area are, in the near term, aimed not so much at U.S. settlors of such trusts, but rather,

has substantially strengthened its audit presence in this area.[32]

The foregoing policy issues underlying the federal government's attention to this offshore trust area reveal an obvious question; specifically: if U.S. persons can easily enjoy (or at least pursue) asset protection benefits by moving in the aggregate substantial sums of money offshore, and if that movement of funds is of such concern and interest to the federal government, *should the same asset protection lure be denied domestically*, where opportunities for abuse would appear to be significantly reduced if for no other reason than the retention of those assets within the U.S. judicial and tax reporting systems?[33] Of course, "if you can't beat 'em, join 'em" is less than persuasive as a rationale for abandoning long held legal principles embedded in current U.S. trust law, such as the prohibition against self-settled spendthrift trusts. Nevertheless, several United States jurisdictions have called into question the continuing validity of centuries old notions of trust law,[34] and the conflicting policy issues thereby raised are not easily resolved. Significant among those policy issues are the questions of what, if anything, should non-APT states and the federal government do in response to this recent movement away from traditional principles of state trust law.[35]

V. THE DOMESTIC RESPONSE—ALASKA AND DELAWARE TRUST LAWS

Alaska and Delaware have not been shy in expressing their respective desire to become the leading trust jurisdiction—not only domestically but also as an alternative to the offshore jurisdictions which have garnered so much world-wide business in the last several years.[36] In fact, one Alaska

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at the unscrupulous promoters of offshore arrangements promising to assist U.S. persons in avoiding U.S. taxes by moving funds offshore.

32. *See Tax Report: The IRS Intensifies Its Scrutiny of Abusive Trusts*, WALL ST. J., Oct. 13, 1999, at A1. The IRS is committing "about 150 additional revenue agents" to this "very . . . fast-growing area of noncompliance." The focus of the IRS's intensified scrutiny currently centers upon promoters of these offshore trust arrangements, rather than upon the settlors of such trusts.

33. This policy argument also was recently recognized by an attorney actively engaged in the asset protection practice. *See Roundtable Discussion*, 32 VAND. J. TRANSNAT'L L. 779, 782 (1999) (comments of Gideon Rothschild, chairman of the American Bar Association Committee on Asset Protection); *see also* Marty-Nelson, *supra* note 5, at 440-41 ("[S]hould two otherwise identical taxpayers face different tax options and consequences stemming wholly from the fortuity of a trust instrument's 'location?'").

34. *See* Joel C. Dobris, *Changes in the Role and the Form of the Trust at the New Millennium, or, We Don't Have to Think of England Anymore*, 62 ALB. L. REV. 543, 560-63 & 572-74 (1998). *See supra* Parts III and VIII.B (discussing some of the state law policy issues raised by the Alaska and Delaware trust legislation).

35. *See* discussion at Part VIII, *infra*.

36. *See supra* note 3 and accompanying text. The legislative histories of both state's statutes

legislator noted the Alaskan legislators "had research that showed large sums of money going over to the Cayman Islands, and asked, 'Why couldn't we do that?' . . . The answer came back: 'We could.'"[37] Both Alaska and Delaware have thus enacted legislation which (1) effectively repeals the rule against perpetuities with respect to most property held in trust;[38] (2) permits self-settled trusts to enjoy protection from the claims of the settlor-beneficiary's creditors, subject to certain conditions;[39] and (3) restricts the time periods for challenging transfers to trusts.[40] As Nevada and Texas have already demonstrated, the Alaska and Delaware legislation will likely serve as the domestic model should other states choose to follow this movement away from the longstanding prohibition against self-settled spendthrift trusts.[41]

A. *Creditor Protection for Settlor-Beneficiary*

The domestic statutes purport to permit the shielding of trust assets from the claims of the settlor-beneficiary's creditors, in direct opposition to the otherwise widely accepted U.S. rule that self-settled spendthrift trusts are not valid against such creditors.[42] In Alaska, this is accomplished through statutory language which expressly permits a person to transfer property in trust and to provide in the trust agreement that the beneficiaries' interests (including the interest of the settlor as beneficiary) may not be voluntarily or involuntarily alienated, except to the extent funds have actually been paid by the trustee to the beneficiary—i.e., trust property is subject to the claims of the beneficiary's creditors only if

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recite this purpose as a key motivation behind the changes. *See id*; *see also Opposing Parties Join Forces to Attract Family Trust Industry to Alaska*, ALASKA J. OF COMMERCE, Apr. 14, 1997, at 6 (describing new trust legislation as being "aimed at luring a multi-billion dollar industry to Alaska . . . [and] intended to make the state a national and international center for administering trusts."); *see, e.g.*, ALASKA STAT. § 13.36.043 (Michie 1998) (permitting change of situs of trust to Alaska).

37. Katharine Fraser, *With New Law, Alaska Aiming to be Trust Capital*, AM. BANKER, Apr. 21, 1997, at 13 (quoting Alaska Rep. Al Vezey, R-North Pole).

38. *See* David G. Shaftel, *Newest Developments in Alaska Law Encourage Use of Alaska Trusts*, 26 EST. PLAN. 51, 52 (1999) (noting Alaska has joined Arizona, Delaware, Idaho, Illinois, Maryland, South Dakota and Wisconsin as states which have abolished the rule against perpetuities). *See, e.g.*, ALASKA STAT. § 34.27.050 (Michie 1998) (abolishing the rule against perpetuities). Query whether any of these other jurisdictions adopting such a pro-trust measure as repeal of the rule against perpetuities might next join the asset protection bandwagon.

39. *See* Blattmachr & Blattmachr, *supra* note 23, at 50; Shaftel, *supra* note 38, at 51.

40. *See* Blattmachr & Blattmachr, *supra* note 23, at 48; Blattmachr et al., *supra* note 10, at B7; Hompesch, II et al., *supra* note 24, at 9; Richard W. Nenno, *Delaware Law Offers Asset Protection and Estate Planning Benefits*, 26 EST. PLAN. 3 (1999); Shaftel, *supra* note 38, at 51-52.

41. *See supra* note 32.

42. *See* DEL. CODE ANN. tit. 12, § 3570(9) (Supp. 1998); ALASKA STAT. § 34.40.110(b)(2) (Michie 1998).

actually removed from the trust and paid to the beneficiary.[43] Such a transfer restriction by statute "prevents a creditor existing when the trust is created, a person who subsequently becomes a creditor, or another person from satisfying a claim out of the beneficiary's interest in the trust. . . ."[44] Although such creditor protection will not be available if the settlor retains the power to revoke or terminate all or a portion of the trust without the consent of a person possessing "a substantial beneficial interest in the trust [which] . . . would be adversely affected by the exercise of [such] power," the statute makes clear that creditor protection will not be lost simply because the settlor retains "the right to receive a distribution of income, corpus, or both in the discretion of a person, including a trustee, other than the settlor. . . ."[45]

The Delaware statute is similarly direct in limiting a creditor's recovery against property that has been the subject of a "qualified disposition."[46] A "qualified disposition" is defined to include transfers (1) to a trustee having the requisite Delaware contacts; (2) under an irrevocable trust instrument; which (3) incorporates Delaware law as governing the validity, construction and administration of the trust; and which (4) "[p]rovides that the interest of the *transferor or other beneficiary* in the trust property or the income therefrom may not be transferred, assigned, pledged or mortgaged, whether voluntarily or involuntarily, before the . . . qualified trustees actually distribute the property or income therefrom to the beneficiary. . . ."[47] The statute further provides that a trust will not be deemed revocable (a circumstance that would thwart the available creditor protection) notwithstanding the settlor's "potential or actual receipt of income, including rights to such income retained in the trust instrument; or [the settlor's] potential or actual receipt of principal if such potential or actual receipt of principal is either in the sole discretion of . . . qualified trustees or is pursuant to an ascertainable standard contained in the trust instrument. . . ."[48]

43. *See* ALASKA STAT. § 34.40.110(a) (Michie 1998).

44. ALASKA STAT. § 34.40.110(b).

45. ALASKA STAT. § 34.40.110(b)(2). The statute is less than artfully drafted in allowing the settlor to be a creditor-protected beneficiary, doing so by implication in defining a power to revoke or terminate as *not* including "a power to veto a distribution from the trust, a testamentary special power of appointment or similar power, or the right to receive a distribution of income, corpus, or both in the discretion of a person, including a trustee, other than the settlor. . . ." *Id.*

46. *See* DEL. CODE ANN. tit. 12, § 3572(a) & (b) (Supp. 1998).

47. DEL. CODE ANN. tit. 12, § 3570(9) (emphasis added).

48. DEL. CODE ANN. tit. 12, § 3570(9)(b)(3) & (4). *See infra* note 222 and accompanying text (regarding the transfer tax concerns and the avoidance of inclusion of trust property in the settlor's estate, any interest in income or principal should be limited to distributions in the absolute discretion of the trustee, notwithstanding creditor protection issues).

B. *Required Trustees and Governing Law*

Both Alaska and Delaware have designed their statutes to increase trust business within the respective states, by imposing certain trustee and administration requirements upon the creditor-protected trust.[49] These pro-local business requirements also collaterally enhance the asset protective features of a trust by increasing the likelihood that the settlor's stated choice of Alaska or Delaware governing law will be honored.[50] "The framers of the new [Alaska] statutory trust provisions considered that persons located outside Alaska may well be interested in using Alaska self-settled spendthrift trusts . . . . Consequently, they enacted statutory requirements which the framers thought would provide an adequate Alaska nexus so that Alaska law would apply to the trust."[51]

In Alaska, this local "nexus" has been pursued in part by providing that an Alaska choice of law provision shall be "valid, effective, and conclusive for the trust if . . . some or all of the trust assets are deposited in [Alaska] and are being administered by a qualified person" having a minimum level of specified trustee powers over the trust.[52] A "qualified person" is a designated trustee who is an individual resident of Alaska, certain trust companies having a principal place of business in Alaska, or a bank having trustee powers under Alaska law and maintaining a principal place of business in Alaska.[53] The minimum powers of this local trustee with respect to a particular trust must include the power to "maintain[] records for the trust on an exclusive basis or a nonexclusive basis; and . . . prepar[e] or arrang[e] for the preparation of, on an exclusive basis or a nonexclusive basis, an income tax return that must be filed by the trust."[54] Finally, part or all of the administration of the trust must occur in Alaska.[55] There is no statutory prohibition against other non-Alaskan persons serving as co-trustee with the required local fiduciary.[56] Thus, it is entirely possible for an out-of-state settlor to utilize someone closer to home as a co-trustee

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49. *See* Shaftel, *supra* note 38, at 52.

50. *See id.*

51. *Id.*; *see also* Nenno, *supra* note 40, at 8 ("The use of non-Delaware trustees would increase the trust's susceptibility to service of process in other jurisdictions and the possibility that Delaware law might be found not to govern the trust, or more importantly, the rights of beneficiaries and their creditors.").

52. ALASKA STAT. § 13.36.035(c) (Michie 1998). As discussed in more detail in subsequent parts of this article, this Alaska legislative declaration of the law that shall govern such a trust may or may not be respected by courts in other states.

53. *See id.* § 13.36.390(1).

54. *Id.* § 13.36.035(c)(3).

55. *See id.* § 13.36.035(c)(4).

56. *See id.* §§ 13.36320(a)(1), 13.36390; *see also* Shaftel, *supra* note 38, at 51 ("[A]s long as there is at least one Alaska trustee, then non-Alaskan individuals, trust companies, and banks may serve as co-trustees. . . .").

to share in investment and/or distribution decisions.

Similarly, Delaware has provided that in order to enjoy the full asset-protective benefits of Delaware law, the trust agreement must designate a "qualified trustee," defined to include individual Delaware residents (other than the settlor) or entities subject to supervision by one of several specified Delaware regulatory bodies.[57] Like the Alaska trustee under that state's legislation, the Delaware trustee must maintain or arrange for custody in Delaware of some or all of the trust property, maintain records for the trust on an exclusive or nonexclusive basis, prepare or arrange for the preparation of fiduciary income tax returns for the trust, "or otherwise materially participate[] in the administration of the trust."[58] The Delaware scheme is again more explicit than Alaska in providing that the settlor may designate non-resident "advisors" or "protectors" who under the trust agreement may be given the authority "to remove and appoint qualified trustees or trust advisers . . . [and] to direct, consent to or disapprove distributions from the trust. . . ."[59] In addition, the settlor may serve solely as an investment advisor without jeopardizing the statutorily granted spendthrift nature of the trust.[60] As noted above, one of the Delaware requirements for a "qualified disposition" is that the trust instrument expressly incorporate Delaware law as governing the "validity, construction and administration of the trust."[61]

Thus, the statutory schemes of Delaware and Alaska make clear that any self-settled DAPT created in one of those jurisdictions will have (1) at least one local trustee; (2) a choice of local governing law provision with respect to the construction, validity and administration of the trust; (3) some portion of the trust property held in the applicable state; and (4) some portion of the administration of the trust taking place within the applicable state.[62] There may, however, be other nonresidents involved in the administration of such a trust. All of these points may prove significant if the asset-protective features of such a trust are challenged in another jurisdiction.

C. *Fraudulent Transfers and Limitations Periods*

Any transfer to an Alaska or Delaware trust will be invalid, and the asset protective features of the trust will be of no avail, if the transfer of property to the trust was fraudulent under general principles of fraudulent

57. DEL. CODE ANN. tit. 12, § 3570(8)(a) (Supp. 1998).
58. *Id.* § 3570(8)(b).
59. *Id.* § 3570(8)(c).
60. *See id.* § 3570(8)(d).
61. *Id.* § 3570(9)(a).
62. *See supra* notes 52-61 and accompanying text.

conveyance law.[63] However, both Alaska and Delaware have tightened the

63. *See* ALASKA STAT. § 34.40.110(b)(1) (Michie 1998) (protection not available if "transfer was intended in whole or in part to hinder, delay, or defraud creditors or other persons under" Alaska's fraudulent transfer laws); DEL. CODE ANN. tit. 12, § 3572(a) (Supp. 1998) (qualified disposition may be avoided under Delaware fraudulent transfer laws); *id.* § 3536(b) (spendthrift provisions not valid to protect property which has been fraudulently transferred).

The Alaska fraudulent transfers statute is fairly simplistic and does not appear to be modeled after either the Uniform Fraudulent Conveyances Act or the more recent and more widely adopted Uniform Fraudulent Transfers Act. Duncan E. Osborne et al., *Asset Protection and Jurisdiction Selection*, 33 U. MIAMI SCH. OF L. PHILLIP E. HECKERLING INST. ON EST. PLAN. ¶ 1404.7(B) (Tina Hestrom Portundo ed., 1999) (discussing Alaska fraudulent transfer laws). Similar to those Uniform Acts, however, the Alaska statute basically provides that transfers are void if

> made with the intent to hinder, delay, or defraud creditors or other persons of their lawful suits, damages, forfeitures, debts, or demands, or a bond or other evidence of debt given, action commenced, decree or judgment suffered, with the like intent, as against the persons so hindered, delayed, or defrauded . . . .

ALASKA STAT. § 34.40.010 (Michie 1998).

The Delaware fraudulent transfers provisions are based upon the Uniform Fraudulent Transfers Act, which has to date been adopted by most American states. *See* UNIFORM FRAUDULENT TRANSFER ACT (1984) 7A Pt. II U.L.A. 266, 266-67 (1999). *See generally* Osborne et al., *supra*, ¶ 1404.7(C) (discussing Delaware fraudulent transfer laws). The Uniform Fraudulent Transfers Act provides in part:

> § 4. Transfers Fraudulent as to Present and Future Creditors.
>
> (a) A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation:
> (1) with actual intent to hinder, delay, or defraud any creditor of the debtor; or
> (2) without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor:
> (i) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or
> (ii) intended to incur, or believed or reasonably should have believed that he [or she] would incur, debts beyond his [or her] ability to pay as they became due.
> (b) In determining actual intent under subsection (a)(1), consideration may be given, among other factors, to whether:
> . . . .
> (2) the debtor retained possession or control of the property transferred after the transfer;
> (3) the transfer or obligation was disclosed or concealed;
> (4) before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;

period within which an action may be brought to challenge the settlor's funding of a self-settled DAPT. Specifically, under the Alaska statute no "cause of action or claim for relief" may be pursued by persons who were already creditors of the settlor at the time of the transfer to the trust, unless brought within four years of the transfer or within one year after the transfer could reasonably have been discovered.[64] As to persons who became creditors of the settlor after the transfer of property to the trust was made, the action must be brought within four years of the transfer.[65] Delaware law is virtually identical, although identity of the creditor for purposes of applying the applicable limitations period is tied to when the "creditor's claim against the transferor arose," rather than to the date such

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(5) the transfer was of substantially all the debtor's assets; . . .

. . . .

(7) the debtor removed or concealed assets;

(8) the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;

(9) the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;

(10) the transfer occurred shortly before or shortly after a substantial debt was incurred.

. . . .

§ 5. Transfers Fraudulent as to Present Creditors.

(a) A transfer made or obligation incurred by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made or the obligation was incurred if the debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer or obligation.

(b) A transfer made by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made if the transfer was made to an insider for an antecedent debt, the debtor was insolvent at that time, and the insider had reasonable cause to believe that the debtor was insolvent.

. . . .

§ 7. Remedies of Creditors.

(a) In an action for relief against a transfer or obligation under this [Act], a creditor . . . may obtain:

(1) avoidance of the transfer or obligation to the extent necessary to satisfy the creditor's claim. . . .

UNIFORM FRAUDULENT TRANSFER ACT §§ 4, 5, 7 (1984), 7A Pt. II U.L.A. 301-02, 330, 339-40 (1999).

64. ALASKA STAT. § 34.403110(d)(1) (Michie 1998).

65. *See id.* § 34.40.110(d)(2).

person becomes a creditor.[66] Interestingly, the Nevada legislature has opted for a more internationally competitive two-year limitations period.[67]

D. *Other Exceptions*

Obviously, if a settlor-beneficiary reserves an absolute right to receive income or principal from a trust, as opposed to a mere right to receive distributions in the discretion of a third-party trustee, the settlor's unfettered right will be subject to attachment by creditors and the trust will thus be ineffective as an asset protection vehicle to the extent of the retained mandatory distribution entitlement.[68] Moreover, in addition to the potential for setting aside a transfer to a self-settled DAPT under the applicable fraudulent transfer rules within the limitations period stated, both Alaska and Delaware have provided for other exceptions to the asset-protective features of trusts created under their statutes.[69] From both a public policy and transfer tax planning standpoint, the differences between the Alaska and Delaware exceptions are significant. For example, in Delaware a settlor-beneficiary may not assert the asset-protective features of a qualified disposition so as to defeat the claim of a dependent spouse or child for support, or the claims of certain tort plaintiffs suffering injury prior to the date of the qualified disposition.[70] Thus, and as discussed in more detail below, it may be impossible for a settlor to make a transfer to a Delaware DAPT and thereafter have the Delaware DAPT assets excluded from the settlor's gross estate, since a narrow but significant exception to the limitations upon the rights of creditors to reach trust property will always be present.[71]

66. DEL. CODE ANN. tit. 12, § 3572(b)(2) (Supp. 1998).

67. NEV. REV. STAT. § 166 (Assembly Bill No. 469, § 1) (Michie 1999).

68. *See, e.g.*, ALASKA STAT. § 34.40.110(b)(3) (excepting from asset protective features of act any trust interest that is a mandatory right to income or principal); DEL. CODE ANN. tit. 12, § 3570(9)(b)(3) & (4) (Supp. 1998) (limiting settlor's interest to discretionary distributions).

69. *See* DEL. CODE ANN. tit. 12, § 3573 (Supp. 1998).

70. *See id.* (providing in relevant part that the following persons are not subject to a "qualified disposition" and thus may avoid the asset-protective features thereof: "any person to whom the transferor is indebted on account of an agreement or order of court for the payment of support or alimony in favor of such transferor's spouse, former spouse or children, or for a division or distribution of property in favor of such transferor's spouse or former spouse, to the extent of such debt; or . . . any person who suffers death, personal injury or property damage on or before the date of a qualified disposition by a transferor, which death, personal injury or property damage is at any time determined to have been caused in whole or in part by the act or omission of either such transferor or by another person for whom such transferor is or was vicariously liable").

71. *See* Douglas J. Blattmachr & Richard W. Hompesch, II, *Alaska v. Delaware: Heavyweight Competition in New Trust Laws*, PROB. & PROP., Jan./Feb. 1998, at 32, 36 (concluding that this provision would cause all assets in a Delaware DAPT to be included in the settlor's gross estate, whereas a different result would pertain under the Alaska statute); *see also* Treas. Reg. § 20.2036-1(b)(2) (as Amended in 1960) ("The 'use, possession . . . or other enjoyment

In contrast, the Alaska legislature has seen fit to provide an exception for dependent children only, and even in that case only if "at the time of the transfer, the settlor is in default by 30 or more days of making a payment due under a child support judgment or order."[72] Nevada has apparently chosen to be even more competitive by providing for no statutory creditor exceptions to the self-settled spendthrift trust features of its legislation. However, relevant to both the Nevada and Alaska statutes is one commentator's opinion that the Delaware

> exception for alimony, child support, and property division is an exception that would almost certainly exist even if it were not in the statute because it is highly unlikely that any court in the U.S. would permit a child to go without support while the settlor/parent was living—perhaps very well—on funds received from a retained interest in trust.[73]

E. *"Bells and Whistles"*

Alaska and Delaware have taken other steps to enhance the asset-protective features of their legislation. Both states limit the exposure of trustees and other advisors. In Alaska, this is accomplished by legislative dictate that the statutory spendthrift language not only protects the settlor-beneficiary's interest in the trust, but also

> prevents a [pre-existing or future] creditor . . . or another person from asserting any cause of action or claim for relief against a trustee of the trust or against others involved in the preparation or funding of the trust for conspiracy to commit

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of the transferred property' is considered as having been retained by . . . the decedent to the extent that the use, possession . . . or other enjoyment is to be applied toward the discharge of a legal obligation of the decedent. The term 'legal obligation' includes a legal obligation to support a dependent during the decedent's lifetime."). Query how this affects the settlor having no minor children or spouse at the time of transfer.

72. ALASKA STAT. § 34.40.110(b)(4) (Michie 1998). This meager exception has led one author to comment that "Macy's bills and child support do not have the same bite, except maybe in Alaska." Dobris, *supra* note 34, at 555.

73. Nenno, *supra* note 40, at 3, 8; *see also* Blattmachr & Blattmachr, *supra* note 23, at 48, 56 n.31 ("An Alaska trust could not be used to avoid child support or alimony payments because neither a judgment for child support nor one for alimony is dischargeable in bankruptcy." (citing 11 U.S.C. § 523(a)(5)). *Cf.* 11 U.S.C. § 541(c)(2) (providing that state spendthrift trust interests are exempt from the claims of bankruptcy creditors if such interests constitute an "applicable nonbankruptcy" restriction under state law). *But see* Blattmachr & Hompesch, *supra* note 71, at 32, 36 (concluding that availability of trust assets to satisfy dependent's support claim is likely to cause all assets in a Delaware DAPT to be included in the settlor's gross estate, whereas a different result would pertain under the Alaska statute).

> fraudulent conveyance, aiding and abetting a fraudulent conveyance, or participation in the trust transaction.[74]

Recourse is expressly limited in such case to the settlor and, to the extent the conveyance was fraudulent, the trust assets.[75] The Delaware legislature was perhaps a bit more reserved in providing simply that a transfer "shall not be treated as fraudulent or otherwise contrary to law for [] purposes of any action against any trustee or any [trust] adviser . . . unless it is shown that such trustee or adviser acted in bad faith."[76]

Delaware has gone one step further by expressly providing that its spendthrift trust provisions are intended to be a restriction on transfer of the settlor's beneficial interest in the trust under applicable nonbankruptcy law, as provided under 11 U.S.C. § 541(c)(2).[77] The Alaska provisions would likely also be deemed such a restriction.

Alaska is apparently unique in providing that even where a trust is set aside on one of the grounds noted above (e.g., the transfers to the trust were fraudulent), a trustee not acting in bad faith

> has a first and paramount lien against the property that is the subject of the trust in an amount equal to the entire cost, including attorney fees, properly incurred by the trustee in a defense of the action or proceedings to void or set aside the trust or the property transfer . . . [and] the beneficiary, including the settlor, may retain a distribution made by exercising a trust power or discretion. . . .[78]

This first lien in favor of the trustee may encourage a vigorous defense against creditor claims and perhaps provide an additional psychological disincentive for creditors to seek recovery against trust assets, although the costs to the trust beneficiaries (and the settlor's wealth transfer plan) could be significant as well.

Thus, both Alaska and Delaware have enacted carefully crafted legislation which on its face permits the establishment of a self-settled spendthrift trust that will not be subject to the claims of the settlor's

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74. ALASKA STAT. § 34.40.110(e) (Michie 1998).

75. *See id.*

76. DEL. CODE ANN. tit. 12, § 3572(d) (Supp. 1998).

77. *See* DEL. CODE ANN. tit. 12, § 3570(9)(c). 11 U.S.C. § 541(c)(2) provides: "A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under [Title 11 of the U.S. Code]." § 541(c)(2). For examples of the application of this provision in the context of a debtor's self-settled trust, see *Dzikowski v. Cameron (In re Cameron)*, 223 B.R. 20, 22 (Bankr. S.D. Fla. 1998), and *Marine Midland Bank v. Portnoy (In re Portnoy)*, 201 B.R. 685, 688 (Bankr. S.D.N.Y. 1996).

78. ALASKA STAT. § 13.36.310(c) (Michie 1998).

creditors where certain threshold conditions are satisfied. Both states have included governing law provisions and situs/administration requirements which may enhance the likelihood that the touted creditor protection benefits will in fact be achieved. However, mere satisfaction with the wording of the domestic statutes is hardly the end of the inquiry.

VI. EFFECTIVENESS OF ASSET PROTECTION TRUSTS

A good deal of the literature concerning the new domestic APT legislation has been written by persons having, to one degree or another, a vested interest in the acceptance of that legislation.[79] However, it appears to be widely recognized that for constitutional and practical reasons, a trust created under domestic statutes cannot provide the same degree of asset protection afforded by an offshore APT:

> It is impossible for any state in the U.S. to offer the same degree of protection as offshore jurisdictions that have high burdens of proof, virtually no recognition of foreign judgments, the English rule for taxing attorney's fees as costs, and extremely short limitations periods in which to seek avoidance of a transfer claimed to be fraudulent.[80]

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79. For example, authors Jonathan G. Blattmachr and Richard Twaites, Jr. are or were shareholders in Alaska Trust Co. *See* Rose Ragsdale, *Alaska Trust Stakes Claim to Service Niche in Banking Territory*, 21 ALASKA J. OF COM., Apr. 21, 1997, at 1 (discussing Alaska Trust Co. and its principals); *see also* Jonathan G. Blattmachr et al., *New Alaska Trust Act Provides Many Estate Planning Opportunities*, 24 EST. PLAN. 347, 347 (1997) [hereinafter *New Alaska*]; Blattmachr et al., *supra* note 10, at B5 (Douglas Blattmachr is President and C.E.O. of Alaska Trust Co.); Blattmachr & Hompesch, *supra* note 71, at 32 (Douglas Blattmachr and Alaska attorney Hompesch, touting the benefits of the Alaska legislation over Delaware law's shortcomings); Nenno, *supra* note 40, at n.a1 (author listed as Vice President and Trust Counsel for Wilmington Trust Company, Wilmington, Delaware). This is not to imply that the literature is by any means either inaccurate or of only promotional value. Indeed, some of the literature is quite informative and has been co-authored by nationally prominent authors in the estate planning field. *See, e.g.*, Blattmachr et al., *supra* note 10 (Howard M. Zaritsky, co-author, has written several treatises on estate planning.). However, some statements are perhaps a little too optimistic, at least given the current uncertainties discussed herein, regarding the potential utilization of the new domestic statutes. *See, e.g.*, James L. Dam, *New Trusts Will Offer Estate Tax Breaks, Protection from Creditors*, LAWYERS WEEKLY U.S.A., Apr. 21, 1997 (quoting Jonathan G. Blattmachr, "If you're making a significant gift, I don't know why you wouldn't use an Alaska trust. . . .").

80. Nenno, *supra* note 40, at 8-9; *see also* SPERO, *supra* note 21, ¶ 6.08(5) ("[T]rusts established under these laws are vulnerable to creditor attack where the settlor/beneficiary is not a resident of one of those states."); Giordani, *supra* note 9, at app. B (detailed discussion of potential weaknesses in domestic legislation); Osborne et al., *supra* note 63 (same); Hompesch, II et al., *supra* note 24, at 9 ("An Alaska trust . . . will not provide the additional practical barriers that are often present with respect to [foreign APT's]."). Credit is due those previously described as having a vested interest in the domestic legislation, for their straightforward acknowledgment of this reality. *See, e.g.*, Hompesch, II et al., *supra* note 24, at 9 (Jonathan Blattmachr, co-author,

A. *Uncertainty Impacts Transfer Tax Planning*

The legal susceptibility of a self-settled DAPT to the settlor's creditors' claims is far from clear, by virtue of the interaction between the strong protection which the drafters have attempted to include in the domestic legislation and the apparent merit to some of the recognized potential weaknesses of such legislation.[81] Nevertheless, absent a new body of case law or other authority indicating that a DAPT will not provide the promised protection, the DAPT presents new possibilities for transfer tax planning situations.[82] Even if future developments establish definitively that DAPTs are fairly weak (relative to OAPTs) as asset protection vehicles, the potential merits of DAPTs as transfer tax planning vehicles should not be ignored. At the very least, the DAPT presents a new element to be considered and discussed with clients in devising a transfer tax planning strategy. This is particularly true for settlors residing in Alaska or Delaware since, in the context of resolving a creditor's claim against trust assets, the arguments for applying a different state's laws and public policy will be much weaker than in the case of a nonresident debtor and nonresident creditors.[83]

The existence of various theories upon which such DAPT legislation might be respected or ignored renders the analysis difficult from the transfer tax planning standpoint. This difficulty expands upon consideration that in a litigated transfer tax dispute in which estate inclusion of trust property is sought by the IRS, the IRS will likely be forced to argue the rights of a hypothetical (as opposed to actual) creditor,[84] which makes it more difficult to predict the court's likely concern for the various theories under which the asset protection features of the DAPT legislation might be honored or ignored. This is because many of those theories turn on public policy and possibly constitutional considerations that are difficult to fully appreciate where there is no actual creditor

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comparing domestic APT benefits to those offered by an offshore APT).

81. *See, e.g.*, CASNER & PENNELL, *supra* note 12, ¶ 4.1.4 n.23 ("It is too early to determine whether creditors from states other than Alaska or Delaware will be able to obtain judgments against the trust that an Alaska or Delaware court will respect....").

82. *See infra* note 127, and accompanying text; *see also New Alaska, supra* note 79 (discussing various uses of a DAPT for transfer tax planning purposes).

83. *See* Blattmachr & Hompesch, *supra* note 71, at 36 ("The greatest degree of certainty may be achieved by an Alaska domiciliary transferring her assets located in Alaska to an Alaska trust and having an Alaska trustee alone hold the power to make or withhold distributions.").

84. Or stated differently, the IRS would be arguing the rights of creditors generally. This concept is also addressed to some extent in Marty-Nelson, *supra* note 5, at 431-37, wherein the author points out that "[c]reditor access cases fall into two categories: (1) cases where a creditor is a party (i.e., 'genuine' creditor access cases), and (2) cases where a creditor is not a party (usually tax disputes involving the Service and the settlor or the settlor's estate." *Id.* at 431.

harmed by the transfer to the self-settled spendthrift trust and no actual judgment, the enforcement of which is sought.

Moreover, in the likely IRS transfer tax dispute argument asserted against the estate of a settlor/decedent residence of a non-DAPT state, there would be no actual debtor-creditor relationship to point to as enhancing the nexus between the trust transaction and the settlor's domiciliary non-DAPT jurisdiction whose law or public policy might otherwise be applied on the basis of that relationship.[85] Similarly, there would be no creditor party whose "expectations" might be cited in determining the most appropriate choice of governing law. It is difficult to believe that in such a situation the court hearing a transfer tax dispute would simply concoct a scenario under which the asset protection features of the DAPT might fail, and therefore hold that trust property is includible in the decedent settlor's gross estate on that basis.[86]

Perhaps the courts would look to the nature of the actual creditors of the decedent-settlor's estate as indicative of the considerations at issue, notwithstanding the potential lack of any unsatisfied creditor claim, in delineating the appropriate creditors' rights considerations. Alternatively, the scenario could be imagined where an actual creditor is pursuing trust assets simultaneously with the litigation of a transfer tax dispute, thus providing at least one situation which could demonstrate to the court the protection afforded by the DAPT. The more likely approach, given the policies underlying estate inclusion based on creditors' rights,[87] is that the courts would look to the rights of creditors generally—herein described as the hypothetical creditor—which in itself raises questions as to how far the courts in transfer tax disputes might go beyond the literal wording of the "applicable" state law to discern a circumstance under which the promised asset protection features of the trust would fail.

The possibilities likely to be entertained by the courts in a transfer tax dispute are discussed in more detail below. However, before considering such issues, it is appropriate first to understand the potential shortcomings and purported strengths of the DAPT legislation.

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85. *See, e.g.*, Marine Midland Bank v. Portnoy (*In re Portnoy*), 201 B.R. 685, 700 (Bankr. S.D.N.Y. 1996) (holding that New York law, rather than law stated in trust, should govern creditors' rights, based on closer nexus to settlor and creditors). The parameters of this conflicts of law issue are discussed more fully in Part VI.B.3., *infra*.

86. The likelihood of such a result is simply another way to view the discussion which follows in the text, *infra*, as to the level of analysis likely to be applied by the courts in hearing a transfer tax dispute involving only a hypothetical creditor. In other words, references to the courts' likely approach to the hypothetical creditor situation is similarly postulating the degree to which the courts will entertain—or deem relevant—the possibility of the DAPT failing to deliver the desired level of asset protection.

87. *See infra* text accompanying note 147.

B. *Strengths and Weaknesses of DAPTs*

Despite the uncertainties and numerous potential creditor scenarios, it is nevertheless important to consider the reasons why a domestic APT might not offer full asset protection to a settlor-beneficiary.[88]

1. Fraudulent Transfers

Asset protection is not afforded a settlor whose transfer of property to the trust constitutes a fraudulent transfer. Creditors need only establish within the jurisdiction's applicable limitations period that a transfer to the trust was fraudulent and should therefore be voided, thus effectively bringing the implicated trust property back into the settlor's hands for attachment by creditors. The Delaware and Alaska legislation provide some degree of debtor-friendly protection in this regard by providing for a reasonably short limitations period in which such challenges may be brought.[89]

88. It is not the author's purpose to present novel arguments which might be asserted by a settlor-beneficiary's creditors in attempting to recover against the assets of a self-settled DAPT. Rather, the above discussion is an attempt to summarize the potential weaknesses in DAPT's as asset protection vehicles, as necessary background to be appreciated (and disclosed to clients) when utilizing DAPT's in the estate and gift tax context hereinafter discussed. For a concise yet thorough discussion of the potential weaknesses in these domestic statutes, see Giordani, *supra* note 9, app. B. Another very detailed discussion of these issues can be found in recent ALI-ABA CLE materials. *See* Karen Gebbia-Pinetti, *As Certain As Debt and Taxes: Estate Planning, Asset-Protection Trusts, and Conflicting State Law*, SC60 A.L.I.-A.B.A. 179, 185-203 (1998) (This article was prepared for the 1998 Advanced Estate Planning Techniques Seminar). Also recommended on the topic of creditor access to the assets held in an APT include Osborne et al., *supra* note 63, ¶ 1404, and Alan R. Jahde & Michael P. Franzmann, *What Are Creditors' Rights Against Asset Protection Trusts*, 26 EST. PLAN. 410 (1999). Recent creditor challenges brought in the United States Bankruptcy courts against OAPTs are discussed in Gideon Rothschild & Daniel S. Rubin, *Offshore Trusts—Onshore Litigation*, PROB. & PROP., Nov./Dec. 1999, at 29-32. The author has relied to some extent upon all of these sources and those cited elsewhere in Part V of this Article in formulating the discussion set forth in Part V of this Article. The author's primary contribution lies in the characterization of these arguments and their impact upon transfer tax planning.

89. *See supra* notes 64-66 and accompanying text with regard to the limitations periods provided under the Alaska and Delaware statutes. In this regard, note that a non-DAPT jurisdiction may not necessarily be bound by the limitations period established under the DAPT jurisdiction's laws. *See* 17 JAMES WM. MOORE ET AL., MOORE'S FEDERAL PRACTICE § 124.32(4) (3d ed. 1999) (noting that a state can "apply its own [statute of] limitations to claims governed by another state's substantive laws without violating either the Full Faith and Credit Clause or the Due Process Clause.") (citations omitted). For a discussion of the issues arising under the Full Faith and Credit Clause and the Due Process Clause in the context of DAPT's, see *infra* text accompanying notes 94-98.

2. Constitutional Concerns

All matters concerning domestic asset protection trust legislation and its effectiveness will be subject to considerations arising under the U.S. Constitution.[90] One constitutional argument can be made only with respect to creditors whose claims arose prior to the transfer to the DAPT. Specifically, the Contracts Clause of the U.S. Constitution can be asserted to invalidate laws which impair contractual obligations, such as those between a debtor and a creditor.[91] One author considers this avenue of attack as "probably the only viable Constitutional claim that could potentially obliterate the new [domestic] asset protection trust laws."[92] However, it would seem that such an argument is tenuous, at best, except as to those creditors able to show that a specific contractual right (as opposed only to a remedy) with regard to the property held by the DAPT has been defeated.[93]

The most often cited constitutional clause proffered in recognition of the potential weakness of the DAPT legislation is the Full Faith and Credit Clause of the U.S. Constitution,[94] which imposes upon each state an "obligation to recognize and enforce the judgments of the courts of sister states."[95] This would be relevant, for example, where a trust is created and administered under the laws of a DAPT jurisdiction and thereafter a judgment is entered against the DAPT settlor-beneficiary by a non-DAPT state having jurisdiction over the settlor-beneficiary—as might be the case, for example, where a New York settlor creates an Alaska DAPT and a judgment is thereafter entered against the settlor by a New York court. Upon delivery of the judgment to the DAPT jurisdiction's courts for enforcement, multiple issues arise, both in favor of and against the effectiveness of the DAPT legislation. For example, although most commentators acknowledge that the DAPT state could be found in violation of the Full Faith and Credit Clause if it were to refuse to enforce the judgment entered by the non-DAPT state's court, considerable questions arise as to the manner of enforcement. In such a case, "[i]t is not

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90. The same is not so when an OAPT is at issue. For others noting this obvious conclusion, see SPERO, *supra* note 21, ¶ 6.08(4); Giordani, *supra* note 9, at W62; Osborne et al., *supra* note 63, ¶ 1404.

91. U.S. CONST. art. I, § 10, cl. 1.

92. Giordani, *supra* note 9, at app. B at W-70; *see also* Osborne et al., *supra* note 63, ¶ 1404.6 (Giordani and co-authors echoing this sentiment). *But see* SPERO, *supra* note 21, ¶ 6.08(4) (discussing contract clause in context of self-settled APT's, and noting case law that may weaken contract clause argument).

93. *See* Giordani, *supra* note 9, at app. B at W-69; *see also* SPERO, *supra* note 21, ¶ 6.08(5) (discussing contract clause arguments).

94. U.S. CONST. art. IV, § 1.

95. 16 JAMES WM. MOORE ET AL., MOORE'S FEDERAL PRACTICE § 108.10 (3d ed. 1998).

clear . . . just what the courts of other states would be bound to do. The prior judgment would not affect directly interests in the [trust] property nor would it impose obligations on the trustee."[96] More specifically, the forum (non-APT) state must have jurisdiction "over the particular person or property in question" to enter a valid judgment entitled to enforcement against such person or property under full faith and credit principles.[97] Personal jurisdiction over a trustee in this context would require that the trustee have the requisite minimum contacts with the forum state, and that the forum state's exercise of jurisdiction over the trustee "be the foreseeable result of the [trustee's] own purposeful conduct, not simply

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96. VA AUSTIN WAKEMAN SCOTT & WILLIAM F. FRATCHER, THE LAW OF TRUSTS § 573 (4th ed. 1989) [hereinafter VA SCOTT & FRATCHER] (discussing Hanson v. Denckla, 357 U.S. 235 (1958)). In *Hanson*, the Supreme Court held that a Florida judgment based on the application of Florida law need not be honored by the courts of Delaware, which jurisdiction was the one in which the trustee and trust property were located and pursuant to which laws the trust was being administered. *See Hanson*, 357 U.S. at 255. Although noting that the Florida judgment was void for lack of jurisdiction over the Delaware trustee or the trust property, Scott and Fratcher point out that the Supreme Court in dicta:

> seems to intimate that a court having jurisdiction over some of the beneficiaries can render a valid judgment as to the validity of the trust that would be binding as between those beneficiaries and perhaps . . . other states would be bound to give full faith and credit to the judgment. It is not clear, however, just what the courts of other states would be bound to do. The prior judgment would not affect directly interests in the property nor would it impose obligations on the trustee. . . . [Scott and Fratcher go on to note that] . . . it may well be argued that the Delaware court would not be bound by the Florida judgment even [if] the Florida court had jurisdiction over the trustee also. A court might acquire jurisdiction over an individual trustee who happened to be in the state or over a corporate trustee [with minimum contacts with the forum state] or the trustee might appear in the action. It is submitted that the judgment would nevertheless be an undue interference with the administration of the trust by the Delaware courts.

VA SCOTT & FRATCHER, *supra*, § 573. It should be noted, however, that the self-serving language in the Alaska and Delaware statutes concerning choice of governing law is not necessarily entitled to full faith and credit in a non-DAPT jurisdiction, as full faith and credit is a concept applicable to the validity and enforcement of out-of-state *judgments*, not statutes. *See* Giordani, *supra* note 9, app. B, at W-70 (noting this limitation); Osborne et al., *supra* note 63, ¶ 1404.6 ("[F]ull faith and credit does not help force the application of Alaska or Delaware law in other states. That issue is resolved under conflicts of laws principles.").

97. 16 MOORE, *supra* note 95, § 108.03. *See* Hanson v. Denckla, 357 U.S. 235, 254-56 (1958) (holding that state of trustee domicile was not bound to give full faith and credit to judgment rendered by state of settlor's and most beneficiaries' domicile, where second state lacked personal jurisdiction over trustee); *see also* 16 MOORE, *supra* note 95, § 130.06[2] ("If the court that rendered the judgment lacked personal jurisdiction . . . that defect . . . renders the judgment 'absolutely void.' Enforcement . . . would violate due process of law."). A good discussion of the jurisdictional and procedural issues which arise in this context is also set forth in SPERO, *supra* note 21, ¶ 6.08(5)(b).

that of . . . third parties [such as the settlor]."[98] If the forum state has jurisdiction over the trustee and/or trust property, then the DAPT is clearly vulnerable.

However, proponents of the DAPT's effectiveness would emphasize the interests of the DAPT state having more significant contacts with the administration of the trust, and in the well-designed DAPT scenario, having more obvious jurisdiction over the trustee and the assets held in trust. For example, the jurisdiction under which the DAPT has been established could protect the trust assets while still enforcing a judgment *against the settlor*, since such a judgment would not necessarily dictate the assets from which the judgment is to be satisfied.[99] Of course, this would not be the case if the non-DAPT state were to simultaneously hold the trust invalid and purport to dictate that trust assets belong to the settlor and thus constitute assets from which the judgment is to be satisfied.[100]

The trustee's contacts with the non-DAPT state and the location of trust property are therefore crucial considerations in the establishment and administration of any APT, as the wrong decision here could mitigate strongly in favor of the judgment creditor.[101] Thus, a primary consideration for both the asset protection attorney and the transfer tax planning attorney is the selection of a trustee with a policy of minimizing personal jurisdiction contacts with states other than the DAPT jurisdiction, the laws of which are intended to govern trust affairs. If such personal jurisdiction is found to exist and due process requirements are otherwise complied with, the asset protection sought could easily be lost as a result of litigation in the non-DAPT jurisdiction.

3. Choice of Laws

The settlor may usually designate in the trust instrument the state law which is to govern the trust, and a DAPT created under Alaska or Delaware law is required to include a provision designating that state's

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98. 16 MOORE, *supra* note 95, § 108.32 (discussing *Hanson v. Denckla*).

99. *See* Giordani, *supra* note 9, app. B, at W65-66 (noting that creditor obtaining judgment against settlor must still seek to enforce the judgment against trust assets).

100. *See* Part VI.B.3., *infra*.

101. In this regard, it is interesting to note that an "Alaska trustee" does not guarantee immunity from the jurisdiction of non-Alaska courts. For example, it appears that a non-Alaska corporation will act as custodian of clients' liquid assets entrusted to Alaska Trust Co. *See* Rose Ragsdale, *Alaska Trust Stakes Claim to Service Niche in Banking Territory*, 21 ALASKA J. OF COM. Apr. 21, 1997, at 1 (noting relationship between D.A. Davidson & Co., with offices in four states, and Alaska Trust Co.). It appears that at least one other potential corporate Alaska trustee may have significant out-of-state contacts. *See* KeyTrust Company National Association, Anchorage, Alaska, Promotional Materials, which may be obtained by calling (800) 982-3811 (KeyTrust is "an affiliate of KeyTrust Company of Ohio . . . ."). A good discussion of the jurisdictional and procedural issues which arise in this context is set forth in SPERO, *supra* note 21, ¶ 6.08(5)(b).

laws as governing.[102] If the law of the DAPT jurisdiction is respected and applied, the DAPT should generally be effective in preserving the trust assets from claims of the settlor's creditors. However, if an action is brought against a settlor-beneficiary in a non-DAPT forum which has jurisdiction over the settlor, that non-DAPT forum may find the self-settled DAPT a violation of its state's public policy, and, therefore, the forum court may apply the laws of the state in which it sits and refuse to recognize the trust as a valid protection against the claims of the settlor's creditors.[103] It is widely accepted that a choice of law provision may be ignored where the laws of the expressly chosen jurisdiction offend the public policy of the forum state in which a legal action concerning the trust is brought.[104]

Several bankruptcy court decisions demonstrate how this line of reasoning might apply in the case of an offshore APT, and such reasoning could be equally applicable in a case concerning the new domestic legislation,[105] although some argue the justifications for such a result would be more limited were a DAPT involved.[106] For example, the court in *Sattin*

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102. *See* BOGERT & BOGERT, *supra* note 15, § 301. With respect to Alaska and Delaware governing law provisions, see *supra* notes 52-61 and accompanying text.

103. *See generally* BOGERT & BOGERT, *supra* note 15, §§ 291 & 301; V A SCOTT & FRATCHER, *supra* note 96, § 573; Marty-Nelson, *supra* note11, at 49-50. There is some difference of opinion as to whether the conflicts of law question is properly resolved by reference RESTATEMENT (SECOND) CONFLICT OF LAWS § 270 (1971), which addresses the validity of a trust generally, or RESTATEMENT (SECOND) CONFLICT OF LAWS § 273, which addresses the more specific question of whether a spendthrift provision restraining a beneficiary's ability to alienate an interest in the trust property, will be given effect. *Compare* Henzy, *supra* note 2, at 747-53 (arguing that the court may apply non-DAPT forum law to invalidate trust where self-settled spendthrift provision violates forum states public policy), *with* Rothschild et al., *supra* note 4, at 768-69 (arguing that *Brooks* and *Portnoy* courts misconstrued the conflicts of law issue, which should have been resolved by specific reference to validity of spendthrift provisions under settlor's choice of law, which should be given effect without regard to public policy of forum state); Rothschild & Rubin, *supra* note 88, at 30 (same); *Roundtable Discussion*, *supra* note 33, at 806 (comments of Gideon Rothschild). Not surprisingly, Henzy is a creditors' attorney, whereas Rothschild and Rubin approach the issue more from a settlor's asset protection viewpoint with respect to the contacts a forum state should have with the debtor-creditor relationship.

104. *See, e.g.*, 17 MOORE, *supra* note 89, § 124.32(4) (noting that choice of law provisions will not be given effect where "[a]pplication of the law of the chosen state would be contrary to a fundamental policy of a state . . . that has a materially greater interest than the chosen state in the determination of the particular issue."); BOGERT & BOGERT, *supra* note 15, § 301, 330 (noting principle in trust context); RESTATEMENT (SECOND) CONFLICTS OF LAWS § 273, discussed *supra* note 103.

105. *See generally* Rothschild & Rubin, *supra* note 88 (discussing the results of several recent bankruptcy decisions involving self-settled offshore APTs); *but see* Rothschild et al., *supra* note 4, at 763 (criticizing bankruptcy court analysis of conflicts of law issue as driven by "bad facts").

106. *See* Hompesch, II et al., *supra* note 24, at 9 (arguing that the logic of such bankruptcy decisions should not apply with equal force in the context of a domestic trust). The authors of the Hompesch article note that the courts in such bankruptcy cases faced "exceptional facts" and the

v. Brooks (In re Brooks) held that spendthrift provisions set forth in Jersey (Channel Islands) and Bermuda trusts funded with property transferred by a U.S. debtor-beneficiary were unenforceable under Connecticut law, which the court found to be applicable notwithstanding contrary choice of law provisions in the governing instruments.[107] A similar decision was reached by the bankruptcy court in *Marine Midland Bank v. Portnoy (In re Portnoy)* where the court similarly refused to honor the settlor's choice of (foreign) law provision and held that property of the offshore trust was includible in the debtor/settlor/beneficiary's bankruptcy estate.[108] In discussing that a self-settled spendthrift trust was violative of the public policy of New York which prohibits self-settled spendthrift trusts,[109] and thus refusing to honor the settlor's choice of law provision in light of that public policy, the court in *In re Portnoy* specifically noted: "it is not at all clear what the policy behind the [offshore jurisdiction spendthrift legislation] is except, perhaps, to augment business."[110] It is clear that similar reasoning could easily be applied by a domestic court outside of Alaska or Delaware in rendering a judgment against a settlor and purportedly refusing to recognize the self-settled trust property as other than belonging to the settlor. Indeed, the *Portnoy* court noted that "[a debtor] may not unilaterally remove the characterization of property as his simply by incorporating a favorable choice of law provision into a self-settled trust of which he is the primary beneficiary."[111] Of course, this once again raises issues as to the forum court's jurisdiction over the trustee and the trust assets, which is a separate inquiry from that of the forum's selection of the applicable governing law.[112]

However, should a bankruptcy court sitting in a non-DAPT forum state hold a debtor/settlor/beneficiary's DAPT ineffective under the foregoing

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courts clearly wanted to reach the given result. *See id.* However, it is not too great a leap to say that such logic could similarly be applied by a court confronting a transfer tax dispute where estate inclusion is in the court's opinion the proper result, the only real question being the grounds upon which the court will so find.

107. 217 B.R. 98, 101, 103-04 (Bankr. Conn. 1998).

108. 201 B.R. 685, 698-701 (Bankr. S.D.N.Y. 1996).

109. This represents a change in (or perhaps a more clear declaration of) New York law since the decision in *Herzog v. Commissioner*, 116 F.2d 591, 596 (2d Cir. 1941). *See infra* notes 181-86 and accompanying text.

110. 201 B.R. at 700.

111. *Id.*; *see also* VA SCOTT & FRATCHER, *supra* note 96, § 598 ("There are situations in which the designation by the settlor of the governing law may be ineffective, even though he designates a state having a substantial connection with the trust [via, e.g., trustee domicile, asset situs, etc.]. On a particular issue of validity the ground for invalidity may rest upon such a strong policy of a state whose law would otherwise govern that the settlor would not be permitted to avoid the policy merely by designating another state as that of the controlling law.").

112. *See* 16 MOORE, *supra* note 95, § 108.04(4) (choice of law and jurisdiction are separate inquiries).

conflicts of law principles, failure of the DAPT as an asset protection vehicle would appear to be imminent, in light of the expansive scope of bankruptcy court jurisdiction over the assets and trustee of any domestic trust.[113] Given that a creditor proceeding against property held in a debtor's APT will likely have doubts as to the debtor's other resources, this bankruptcy pitfall should not be overlooked by those seeking asset protection for debtors residing in non-DAPT states. Indeed, at least one commentator has emphasized that "bankruptcy courts are really going to be the battlegrounds on these [asset protection trusts]."[114] It thus seems plausible to argue that until the movement away from the common law prohibition against self-settled spendthrift trusts becomes more widespread, the true significance of the domestic legislation is in the context of transfer tax planning.

C. *Other Questions*

The foregoing considerations necessarily raise the question of whether it would ever be prudent for an attorney to advise a non-DAPT state resident to whom asset protection is of primary relevance, to utilize a domestic trust in lieu of a trust created, administered and (at least purportedly) governed by the laws of an offshore jurisdiction. Indeed, even in a case resulting in a holding such as those in *In re Brooks*[115] and *In re Portnoy*,[116] the creditors may never actually reach the assets held by the foreign trustee in (or at least perhaps not traceable beyond) the foreign jurisdiction. Such a result cannot be said with any degree of certainty to be likely in the case of assets held in a DAPT established by a settlor who is a nonresident of the DAPT jurisdiction. This is particularly so where activities of the trustee are likely to render that trustee subject to the jurisdiction of a state having an express public policy against recognizing self-settled spendthrift trusts. However, where asset protection is only a secondary consideration (which might be the case in some transfer tax planning situations as discussed below), the domestic statutes may provide adequate protection and do exhibit characteristics which are very relevant in the transfer tax planning context.

Moreover, offshore APTs are not the panacea many people believe

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113. *See generally* Henzy, *supra* note 2, at 745-47, 753-55 (1999) (discussing bankruptcy court jurisdiction and full faith and credit issues); SPERO, *supra* note 21, ¶ 6.08[5][a] & [b][i] (discussing conflicts of law principles and bankruptcy court jurisdiction, and in this context noting that "[i]f the public policy issue is raised outside of Alaska or Delaware, then the asset protection aspects of a self-settled trust will likely be invalidated.").

114. *Roundtable Discussion*, *supra* note 33, at 785 (comments of Eric Henzy, the creditor's attorney in the *Brooks* case, discussed in the text accompanying *supra* notes 105-12).

115. 217 B.R. 98, 104 (Bankr. Conn. 1998).

116. 201 B.R. 685, 703 (Bankr. S.D.N.Y. 1996).

when it comes to asset protection, and are thus not, per se, better than a domestic APT in every given situation. For example, as the new era of offshore APT's matures, stories have arisen of creditors successfully realizing on their claims against the assets of such trusts.[117] In fact, the creditors in both *In re Brooks* and *In re Portnoy* were ultimately able to realize to some extent upon their claims.[118] Moreover, that the security afforded by OAPT's may be called into question is evidenced by a subspecialty which has developed in the field of asset protection as the flipside of the usual fare—that is, the representation of creditors attempting to collect from assets held offshore in OAPT's.[119] While it is true that a creditor may face significant hurdles notwithstanding the invalidation of an offshore trust arrangement, such OAPTs are not an automatic dead end for the persistent creditor or bankruptcy trustee. For example, in *In re Brooks*, primary among trust assets were stock certificates representing interests in certain corporations organized under the laws of Connecticut.[120] Since the stock certificates were issued under authority of Connecticut law, the court would arguably have the power to enforce its judgment by voiding the certificates issued to the offshore trusts, and requiring that new certificates be issued in favor of the bankruptcy trustee.[121] A similar result should obtain where OAPT investments are traceable to United States financial markets.[122]

VII. ESTATE AND GIFT TAX PLANNING IMPLICATIONS

A simple concept applied in most every transfer tax planning situation involving significant wealth is that it is more tax efficient to make current

117. *See, e.g.*, Brigid McMenamin, *Your Trust Has a Hole*, FORBES, June 15, 1998, at 240 (relating stories of settlements and claims realized against offshore APT's and/or their settlors); William Symonds, *Offshore Trusts: Not So Watertight*, BUS. WK., Jul. 26, 1999, at 100 (discussing potential failings of OAPT in recent Florida and other controversies).

118. The creditor in *In re Brooks* recovered "approximately 50 cents on the dollar," while the creditor in *In re Portnoy* recovered "approximately 20 cents on the dollar." Rothschild & Rubin, *supra* note 88, at 32.

119. *See id.* (noting story of Ronald Rudman, formerly a leading practitioner in the legal field of OAPT planning, who has abandoned that practice and now "buys up seemingly hopeless claims against people who have offshore trusts, then sets about to collect them.").

120. *In re Brooks*, 217 B.R. at 101.

121. *See* McMenamin, *supra* note 117, at 240 (discussing this failure in the *Brooks* case, to which the debtor's attorney could only reply "nothing went wrong with the trusts"); *see also* VA SCOTT & FRATCHER, *supra* note 96, § 597 (pointing out that the law of the jurisdiction in which personal property is transferred often governs the validity of that transfer, and recommending that a settlor travel to the jurisdiction in which the trust is to be administered in order to effect transfer of personal property to such trust).

122. Baker, *supra* note 2, at 54 (relaying story of spouse able to realize $3,400,000 on trust assets invested by foreign trustee in the United States).

gifts than testamentary transfers.[123] This is particularly true where the donor's applicable credit amount and annual gift tax exclusions are taken into consideration as reducing the donor's immediate out-of-pocket transfer tax costs, and even where there are immediate transfer tax costs, the tax-exclusive nature of the gift tax versus the tax-inclusive nature of the estate tax still weighs in favor of lifetime gifting.[124] Another important advantage of lifetime gifting is that post-transfer appreciation in the value of gifted property will escape transfer taxation at the progressively increasing transfer tax rates, if the gift is properly structured so that the gifted property is not included in the donor's taxable estate at death. Recent reductions in the capital gains tax rate enhance this accepted principle by discounting the value of the foregone basis step-up at death, relative to the potential capital gains tax likely to be imposed upon the sale of appreciated assets by the donee subsequent to the date of the gift.

Nevertheless, an equally simple concept which is often times more difficult for a client to accept is that property must be given away absolutely and without retained interests in order for the gift to be complete and the property not to be subject to inclusion in the donor's taxable estate at death.[125] Traditionally, this has meant that a donor—such as the settlor of a trust—could not gift property in trust and retain a right to distributions from the trust through the date of death, at least not if the gift was intended to remove property from the donor's gross estate for federal estate tax purposes. This is particularly so in light of the widely accepted Restatement rule which prohibits self-settled spendthrift trusts and, thus, renders the assets of such trusts subject to the claims of the settlor's creditors.[126] Property transferred subject to such a retained interest is generally subject to inclusion under one or all of Internal Revenue Code (IRC) sections 2036, 2037 and 2038.

Proponents of the new DAPT legislation claim that the legislation presents new opportunities in the transfer tax planning arena.[127] However,

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123. *See, e.g.*, BORIS I. BITTKER & LAWRENCE LOKKEN, 5 FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS, ¶ 120.2.2 (2d ed. 1993) (discussing tax advantages of lifetime gifting versus testamentary transfers); CASNER & PENNELL, *supra* note 12, ¶¶ 6.0 & 6.2 (discussing transfer tax advantages of lifetime gifting versus testamentary transfers).

124. *See* BITTKER & LOKKEN, *supra* note 123, ¶ 120.2.2.

125. *See* BITTKER & LOKKEN, *supra* note 123, ¶ 126; STEPHENS ET AL., *supra* note 5, ¶¶ 4.08-.10.

126. *See supra* notes 13-18 and accompanying text for the Restatement rule, and Part VII.E.1, *infra*, for a discussion of the impact of creditor access to trust property upon inclusion of such trust property in the settlor's gross estate at death.

127. The domestic opinion presents "new" opportunities, notwithstanding the prior existence of the offshore alternatives, for several reasons. Foremost among those are (i) the lower costs associated with the creation of an APT domestically; (ii) the retention of assets in the more stable and perceptibly more secure United States financial markets, and the trustee's domestic locale; and

such analysis is most often either presumptive of (or at least overly optimistic about) the asset protection effectiveness of the legislation, or innocuously caveated with reference to the possible shortcomings of such legislation from an asset protection standpoint. Such analysis commonly includes only casual reference to the black-letter rules discernable from the body of transfer tax law pertaining to tax-relevant retained interests, and particularly creditors' rights with respect to property subject to such retained interests.[128] The purpose of the discussion which follows is to more closely consider the implications of the new domestic asset protection trust legislation, with an emphasis on specific transfer tax planning considerations.

Posited in the discussion which follows is that, absent significant precedent undermining the effectiveness of the DAPT legislation, no applicable credit amount or similar gift in trust should be undertaken without at least some *consideration* being given to utilizing one of the DAPT statutes for creation of the trust.[129] While proceeding under the laws of one of these DAPT jurisdictions will not always be the best choice, and

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(iii) the absence of the "stigma" associated with establishing an offshore arrangement associated with the less reputable clientele making the new with respect to such arrangements. *See, e.g.*, Henzy, *supra* note 2, at 740-41 (noting that domestic option may be approximately one-third the cost of offshore alternative, with an aura of security accompanying the domestic option); McMenamin, *supra* note 117, at 240 (relating stories of offshore trust settlors and their questionable motivations); Baker, *supra* note 2, at 54 (relating story of husband perpetrating what amounts to a fraud upon his wife via utilization of an offshore APT); *see also* text accompanying *infra* note 135. Of course, the opportunity for potential transfer tax advantages has been present for some time with respect to offshore APT's. Marty-Nelson, *supra* note 5, at 415-27 (analyzing comparative transfer tax advantages of OAPTs relative to domestic trusts). As recently as 1996, a then accurate analysis of this area was aptly concluded as follows: "Given the pronounced trend *away from* protection of assets in domestic self-settled discretionary trusts and growing acceptance of the Restatement's rule on this score, creating domestic self-settled discretionary trusts immune to estate tax inclusion is an uphill struggle at best." *Id.* at 440 (emphasis added).

128. *See, e.g.*, *New Alaska*, *supra* note 79, at 347 (discussing potential transfer tax planning opportunities presented by new legislation). Particularly intriguing is the prospect of a transfer to a Grantor Retained Annuity Trust (GRAT) or Grantor Retained Unitrust (GRUT), which, under current thinking, provides the settlor with an income stream for a set number of years and a present value discount on the gift tax value of the transferred remainder interest. Once the retained income stream lapses, the settlor must relinquish all interests in the trust property to achieve the desired exclusion of the trust remainder from the settlor's gross estate at death. The authors of the foregoing article suggest that the settlor of a GRAT or GRUT created under one of the new DAPT statutes could retain a discretionary interest in the trust assets, even after the mandatory income interest terminates, and still achieve the desired exclusion of the trust remainder from the settlor's gross estate at death. *See id.* at 354. In this current era of low interest rates, this scenario presents attractive gift tax planning opportunities for the donor otherwise reluctant to set an absolute and unconditional time limit on the settlor's potential receipt of income from the gifted property.

129. Indeed, some APT advocates have opined that, at least in the asset protection context, failure to recommend an APT as a viable option could constitute malpractice. *See, e.g.*, Marty-Nelson, *supra* note 11, at 73 (noting but by no means endorsing this view).

in some cases would be a very bad choice for a given client, there are nevertheless certain clients who could be well served by utilizing these DAPT laws in their wealth transfer planning. However, questions about the ability of the new laws to withstand a frontal assault by a persistent creditor, coupled with existing precedent in both the bankruptcy and tax areas, make proceeding under some of the promoted strategies quite risky.[130]

Thus, while certainly worthy of consideration and discussion with clients, it is unlikely that the new legislation will drastically change the current estate and gift tax planning parameters for residents of states with an established public policy against self-settled APT's, at least absent a significant ruling upholding either the promised creditor protection for a nonresident of the jurisdiction adopting the favorable DAPT legislation, or more directly upholding the promoted estate tax benefits of a DAPT. It must be emphasized that one of the purposes of the foregoing discussion as to the possible weaknesses in DAPT legislation is that a settlor contemplating a taxable gift to a DAPT must not go unadvised that, should the creditor protection aspects of the DAPT fail, a gift tax will have been paid (or exclusions and credits exhausted) without realization of benefit by the ultimate trust beneficiaries to the extent trust property is recovered by creditors.[131] This risk alone may or may not outweigh the client's desire to establish a DAPT with a retained right to discretionary distributions therefrom, while simultaneously treating the arrangement as a completed gift intended to remove property (and appreciation thereon) from the settlor's gross estate at death. Weighing the desired transfer tax planning outcome with the potential creditor exposure must ultimately be resolved by the client after careful discussion with counsel of issues such as those discussed in this article.

A. *Client Situations*

The question naturally arises as to what *transfer tax* clients might benefit from the new DAPT legislation. Not every client contemplating a significant gift or ongoing gifting plan will be benefitted by the new legislation. For example, a wealthy client with little liability exposure (attributable to other than life in a litigious society) and having few apprehensions about irrevocably parting with, say $1,300,000 of property through an applicable exclusion amount gift in trust, would have little need to take advantage of the new DAPT legislation. After all, if the client has

130. *See supra* Part VI.

131. *See* Dam, *supra* note 79 (noting that the opportunity to do other planning could be lost if reliance is placed on a domestic APT which ultimately fails to achieve the desired creditor or transfer tax benefits).

no qualms about the transfer and is exceedingly unlikely to ever care (apart from future estate tax savings) that he or she has parted with the funds, there is no need to risk estate taxation or liability exposure by having that donor retain a discretionary interest in the trust to which such property might be gifted—at least not in the current environment of uncertainty surrounding the effectiveness of the new legislation. As an additional example, a wealthy client desirous of reaping the transfer tax benefits of currently gifting $1,300,000 of property through an applicable exclusion amount gift but apprehensive about the transfer due to more than moderate liability exposure, may be better advised to utilize an offshore trust in light of the practical and constitutional arguments which weigh in favor of offshore arrangements where asset protection is a primary motivation.

In contrast, there are numerous categories of clients interested in lifetime gifting who might very well benefit from the new domestic legislation. Such clients realize the potential benefits of lifetime gifting and wish to avail themselves of some of those benefits, but are nevertheless reluctant to part with any of their personal funds for fear of future need—such fear arising notwithstanding the level of client wealth retained and for reasons generally unrelated to the more specific types of creditor concerns often prompting the creation of offshore APTs. This reluctance is not an unknown phenomena, and the potential advantage to be taken of the new domestic APT legislation has not gone unnoticed.[132]

For example, a wealthy couple might wish to place significant assets in trust for the ultimate (but not necessarily immediate) benefit of their several children.[133] Although the risks of adverse creditor claims against the donor couple might currently seem low, such donors may nevertheless be hesitant to take any action at all due to concern over their own future needs. Such concern might arise, for example, by virtue of the intensely competitive nature of a closely-held business which generated (and still accounts for) a significant portion of the donor couple's wealth. The option of gifting the property but retaining some connection thereto—even if the connection is only in the form of a trustee's discretionary power—provides an added element of flexibility and comfort to such donors in carrying out

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132. *See, e.g.*, CASNER & PENNELL, *supra* note 12, ¶ 6.2 (noting that a primary reason for not making lifetime gifts is "fear that the remaining assets will be inadequate to support the donor for the balance of the donor's life."); *New Alaska*, *supra* note 79, at 347 ("A major impediment to individuals making lifetime gifts for estate planning is concern over losing all interest in the property given away."); Shaftel, *supra* note 38, at 56 ("Alaska self-settled discretionary spendthrift trusts become a very attractive gift giving vehicle for a certain group of donors. These are donors who would benefit from substantial annual exclusion and applicable credit gifts, but who also worry that, in the future, they might need the assets given away.").

133. Indeed, such lifetime gifting plans are often recommended by estate planning practitioners as a fundamental component of a wealth transfer tax planning strategy. *See supra* text accompanying notes 124-31 (discussing lifetime versus testamentary transfers).

their intended plans.[134] Moreover, for many such donor couples, the option of entrusting their funds to anyone outside the U.S. is either patently unappealing or otherwise viewed as overly complicating the gifting plan, and the odds of such an approach being adopted by many such couples would perhaps be nil in light of the foreign trust reporting requirements and other psychological impediments to going offshore.[135]

Although there are certainly unanswered questions about the new domestic APT legislation, the discussion below should make clear that the practitioner discussing transfer tax planning options with clients should, at minimum, advise many such clients as to the *possibility* of utilizing a domestic trust in which the client can retain a discretionary right to income and/or principal. The discussion set forth herein is informative, not only as to the availability and plausibility of such a plan and the types of considerations to be taken into account should such a plan be adopted, but also with regard to the types of disclosures that would absolutely be required to permit the client to fully appreciate the risks and unknowns in so proceeding. In considering the discussion of transfer tax laws which follows, the potential benefits and risks of a DAPT—as discussed previously in Part VI of this article, should be kept in mind.

B. *Estate and Gift Tax Overlap*

There are both gift and estate tax implications where a settlor transfers property to a trust of which the settlor also is a beneficiary. The original transfer to the trust may be structured as a completed gift subject to immediate gift taxation, or the gift may, for transfer tax purposes, be structured as incomplete such that no gift taxes are due at the time of transfer.[136] Whether the gift is complete or incomplete often turns upon the extent to which the settlor retains the power to alter the beneficiaries' enjoyment of the transferred property.[137] Such a power might exist, for example, if the settlor creates a discretionary trust but retains a testamentary power to appoint trust assets among the beneficiaries in a proportion different from that otherwise specified in the trust instrument—in which case the gift will be deemed incomplete and no gift

134. Indeed, such a gift of closely-held business stock to a domestic APT could ultimately facilitate a sale of the closely-held business entity, since the settlor-patriarch may feel less compelled to retain a salaried interest in the entity than might be the case had a significant stock interest been given away absolutely.

135. *See* Dam, *supra* note 79 ("While the Alaska law doesn't offer as much protection as foreign trusts, it eliminates some of the dangers, complications and costs and may be attractive to many people who don't want to move their assets overseas.").

136. *See* Treas. Reg. § 25.2511-2 (as amended in 1983) (discussing complete versus incomplete gifts).

137. *See id.*

taxes will be imposed upon the settlor's transfer of property to the trust.[138] Similarly, if under applicable state law the transferred property remains subject to the claims of the settlor's creditors following the transfer to the trust, the gift will not be deemed complete for transfer tax purposes, since the settlor can affect the other trust beneficiaries' enjoyment of the trust property by incurring debts to which the trust property may be subjected.[139]

In contrast, a gift to a self-settled trust will be deemed complete, and thus taxable where, "under applicable state law the trustee's decision as to whether to distribute trust assets to the grantor is entirely voluntary [and] [t]he grantor cannot require that any of the trust's assets be distributed to the grantor nor can the creditors of the grantor reach any of the trust's assets. . . ."[140] Moreover, property transferred by lifetime gift may be includible in the donor's taxable estate at death if a prohibited interest in or power over the transferred property is retained by the donor—notwithstanding that a gift tax may have been imposed on the transfer at the time of the gift.[141]

Because of this overlap between the estate and gift tax regimes, many of the cases discussed below are exclusively estate or gift tax cases but turn upon the same basic issue. That issue involves the extent of the settlor's retained ability to affect the disposition or enjoyment of trust assets, which, in the self-settled trust context, is often implicated by the extent to which state law permits the settlor-beneficiary to subject trust assets to the claims of the settlor's creditors. Also relevant in the context of a self-settled trust is whether there exists an implied agreement between the settlor and the trustee as to the continued enjoyment of the trust property by the settlor, such as through an understanding that the settlor will receive all of the trust income notwithstanding a trust instrument which expressly provides for trustee discretion over such matters. In the gift tax context such issues affect whether or not a gift is complete, and therefore taxable at the time of transfer, and in the estate tax context such issues affect the extent to which the settlor has failed to fully relinquish all rights in or powers over the transferred property such that all or some portion thereof will be

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138. *See* Treas. Reg. § 25.2511-2(b).

139. *See* Rev. Rul. 76-103, 1976-1 C.B. 293.

140. Rev. Rul. 77-378, 1977-2 C.B. 347; *see also* Treas. Reg. § 25.2511-2(b) ("As to any property, or part thereof or interest therein, of which 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, the gift is complete. But if upon the transfer of property . . . the donor reserves any power over its disposition, the gift may be wholly . . . or partially incomplete. . . .").

141. *See* STEPHENS ET AL., *supra* note 5, ¶ 10.10(10) ("As a basic principle, it can be stated that a transfer treated as complete for gift tax purposes is not necessarily similarly treated for purposes of either the income tax or the estate tax."); BITTKER & LOKKEN, *supra* note 123, ¶¶ 126.3.6 & 132.3 (discussing unified estate and gift tax system and gross estate inclusion of property previously transferred by completed taxable gift).

taxable in the settlor's estate at death.

This estate and gift tax overlap implicates one of the policy concerns of the IRS in evaluating the challenges which have been raised and which may be raised against self-settled trust transactions. Case law and informal conversations with IRS personnel reveal the problem of a settlor-beneficiary claiming a nontaxable incomplete gift upon funding a trust, by virtue of one of the proscribed retained interests discussed below—and then at the settlor's subsequent death, his or her estate failing to report the trust assets as includible in the settlor's estate on the theory that the interest retained was insufficient to result in estate inclusion.[142] The following discussion of the potential use of DAPTs in wealth transfer planning is focused upon the circumstance of a wealthy client desiring to make a completed taxable gift of property which will not be brought back into the settlor's gross estate at death.

C. *Statutory Background*

Although there is considerable overlap among the various statutory provisions which are most likely to result in federal estate taxation of property transferred to a self-settled DAPT,[143] Internal Revenue Code sections 2036(a)(1) and 2038(a) are most often the point of dispute in retained interest transfer tax cases, and in particular those cases where retention is claimed by virtue of creditors' rights to reach the settlor's interest in trust property or by virtue of an implied agreement as to the settlor's continued enjoyment of trust property.[144]

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142. *See, e.g.*, Estate of Paxton v. Commissioner, 86 T.C. 785, 801-02 & n.8 (1986) ("[The Commissioner] has accompanied his arguments with repeated expressions of concern about the potential abuses of the family trust concept in the estate and gift tax fields."); CASNER & PENNELL, *supra* note 12, ¶ 6.02 (discussing a potential whipsaw). The concern expressed in *Paxton* apparently arises out of the inconsistent arguments that taxpayers sometimes assert, depending upon whether the tax controversy concerns a gift tax issue—e.g., the taxpayer argues that the transfers were incomplete, or that the donor received something of equal value in return, thus avoiding gift taxation—or an estate tax issue—e.g., the taxpayer argues that the transfers were complete when made and no taxable interests were retained, or that what the donor received as consideration for transfer and still retained at death really had no value, thus avoiding estate taxation.

143. *See* Dodge, *supra* note 5, at 270-71 (discussing common legislative origin of IRC sections 2036-2038 and the considerable, and often confusing, overlap between those provisions).

144. The right of the settlor's creditors to reach trust property has sometimes been described as a settlor-retained interest in the transferred property under IRC section 2036(a)(1), and sometimes as a power of revocation under IRC section 2038. *Compare* Rev. Rul. 76-103, 1976-1 C.B. 293 (creditors' rights akin to settlor's power to terminate trust), *with Estate of Paxton*, 86 T.C. at 814 ("Retention of the right to use the trust as a form of security for his indebtedness [by virtue of creditors' rights to trust property] left [the settlor] with a significant interest in the property... that is sufficient to require [the settlor's] transfers to the trusts to be included in his gross estate under section 2036(a)(1).").

Other estate and gift tax provisions of primary relevance to the advisor contemplating the implications of the new domestic legislation on a major wealth transfer plan include Internal Revenue Code:

- Section 2037, which brings into the settlor's gross estate property which can only be enjoyed by other beneficiaries if they survive the settlor, and as to which property the settlor has retained a reversionary interest which exceeds in value (at the time of the settlor's death) 5% of the value of the transferred property. *See* I.R.C. § 2037 (1996). However, since it is unlikely that a DAPT would be drafted such that inclusion would result under IRC § 2037 alone, this section will not be discussed in detail. *See* Dodge, *supra* note 5, at 267-78 (discussing situations to which IRC sections 2036 and/or 2037 apply). For a case in which estate inclusion was sought but denied under IRC sections 2035, 2036, 2037 and 2038, see *Clark v. United States*, 209 F. Supp. 895 (D. Colo. 1962).

- Section 2033, which will bring into the settlor's gross estate any property which the trustee decides to distribute to the settlor-beneficiary of the trust and which the settlor does not thereafter expend or otherwise dispose of prior to death. *See* I.R.C. § 2033 (1996). IRC section 2033 provides: "The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death." *Id.*; *see also* Dodge, *supra* note 5, at 271 ("The income or corpus actually received will augment the transferor's section 2033 gross estate."). With regard to the interrelationship of IRC section 2033 and the IRC section 2036(a)(1) principles discussed see STEPHENS ET AL., *supra* note 5, ¶ 4.08, where the authors note that

  > as far as . . . section [2033] is concerned, an individual could gratuitously transfer property in trust, ridding himself of legal title, and yet retain the right to income from the property for life without having his estate suffer an estate tax liability with respect to the property upon his death. This, of course, would be a real cake-and-eat-it scheme; but it is frustrated by section 2036(a)(1). In general, this section [2036(a)(1)] includes in the gross estate the entire value of property so transferred by the decedent. . . .

- Section 2035, which brings into the settlor's gross estate property interests transferred and property over which the settlor relinquished a power, within three years of death, which interest or power otherwise would have resulted in the inclusion of such property in the settlor's gross estate under IRC sections 2036-2038, if such interest or power had been retained by the settlor until death. *See* I.R.C. § 2035(a)(1) & (2) (1996) (applying to decedents dying after August 5, 1997). Planners should take note of this provision when contemplating a self-settled DAPT, because if the case law should develop unfavorably after a self-settled DAPT is funded, this three year rule could become relevant should the settlor then relinquish any interest in the trust.

This discussion omits reference to some of the more obvious estate inclusion problems, some of which would also serve to defeat the asset protective benefits of the new domestic legislation. For example, if the settlor were to retain a right to receive mandatory income distributions from a self-settled trust, at least a portion of the trust property would clearly be includible in the settlor's gross estate under IRC section 2036(a)(1), and the asset protection benefits afforded under the Alaska and

1. Section 2036(a)(1)

Section 2036(a)(1) of the IRC will bring into the settlor's gross estate transferred property if the settlor retains "the possession or enjoyment of, or right to the income from, the property. . . ."[145] In the context of a DAPT of which the settlor is a beneficiary, inclusion is most likely to result through either (i) the settlor's retained enjoyment of the property by virtue of an implied agreement between the settlor and the trustee to that effect; or (ii) the settlor's retained interest in the trust property, which interest may be deemed to exist solely by virtue of the settlor's ability to use the trust as a form of security for the settlor's indebtedness, where under state law the settlor's creditors can reach trust property in satisfaction of the settlor-beneficiary's obligations.[146]

The purpose behind IRC section 2036(a)(1) is to bring into a decedent's gross estate property transferred during life but in a manner akin to a testamentary transfer by virtue of the interests which the decedent retained in the property until the time of death.[147] "The philosophy underlying these [2036(a)] rules is not troublesome; if the transferor retains in himself essentially full lifetime benefits from transferred property, the ultimate shifting of enjoyment at [the transferor's] death is sufficiently akin to testamentary disposition of property to justify the imposition of estate tax at that time."[148]

2. Section 2038

Similarly settled principles under IRC section 2038 require property to be included in the settlor's gross estate where the settlor has retained a power "to alter, amend, revoke or terminate" any other person's beneficial enjoyment of the property.[149] While there is considerable overlap with the IRC section 2036(a)(1) principles noted above,[150] the general theory of IRC

Delaware statutes would be lost to the extent of the mandatory right. In addition, although both the Alaska and Delaware legislation allow a settlor to retain a right to veto distributions from a trust without jeopardizing the asset protection benefits to the settlor-beneficiary, such a retained veto power would also result in the inclusion in the settlor's estate of the property subject to the power, under IRC section 2036(a)(2) and/or section 2038. For a discussion of the overlap between IRC sections 2036 and 2038 on this latter point, see BITTKER & LOKKEN, *supra* note 123, ¶ 126.6.7.

145. I.R.C. § 2036(a)(1) (1996).

146. *See, e.g.*, *Estate of Paxton*, 86 T.C. at 808 (holding IRC section 2036(a)(1) estate inclusion appropriate under both theories).

147. *See* Estate of Whitt v. Commissioner, 751 F.2d 1548, 1558 (11th Cir.), *cert. denied*, 474 U.S. 1005 (1985).

148. STEPHENS ET AL., *supra* note 5, ¶ 4.08(4)(a)

149. I.R.C. § 2038 (1996).

150. *See, e.g.*, Outwin v. Commissioner, 76 T.C. 153, 168 n.5 (1981) (noting that creditors'

section 2038(a)(1) inclusion with respect to a self-settled trust is that the settlor is deemed to have retained the power to terminate the trust by incurring debt and thereby relegating the settlor's creditors to the trust property for satisfaction of their claims.[151] Of course, this would only be the case if applicable state law provided creditors with the right to pursue the trust property by virtue of the settlor's retained rights in the trust property.

That these policies and principles represent the law relevant to property held in a self-settled trust is not an issue of contention.[152] What is open to debate, however, is the manner in which these principles will impact a wealth transfer plan which includes a self-settled DAPT created under one of the new domestic statutes. As will be seen below, it is not merely the retention of a right to receive distributions in the absolute discretion of a third-party trustee which implicates these policies and principles. Rather, something more is required, such as the state law rights of creditors to reach the property subject to the discretionary power, or an implied agreement as to how that discretion will be exercised.

D. *IRS Rulings*

The IRS is clear (and correct) in its position that the assets of a self-settled trust will be includible in the settlor's gross estate to the extent the settlor retains an interest in those assets.[153] More specifically, the rights of the settlor's creditors to reach trust property will result in a gift transfer to the trust being deemed incomplete and therefore not taxable,[154] and will also lead to inclusion of the trust property in the settlor's estate to the extent of the interest reachable by such creditors as of the date of the settlor's death.[155]

In this regard, although federal law determines the transfer tax consequences of such rights, the extent of such rights are determined under applicable state law.[156] A review of the relevant rulings seems to reveal a tendency on the part of the IRS to base its estate and gift tax conclusions upon the stated law of the jurisdiction to which a self-settled trust is

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rights to reach trust property may result in estate inclusion under IRC section 2036(a)(1) or IRC section 2038(a)(1)). This overlap is discussed in STEPHENS ET AL., *supra* note 5, ¶ 4.10(1).

151. *See* Rev. Rul. 76-103, 1976-1 C.B. 293.

152. *See, e.g.*, Estate of Paxton, 86 T.C. 785, 808 (1986); Estate of German v. United States, 7 Cl. Ct. 641, 642 (1985); Estate of Green v. Commissioner, 64 T.C. 1049, 1061-63 (1975) (acknowledging and applying these principles).

153. *See* Rev. Rul. 77-378, 1977-2 C.B. 347.

154. *See id.*; Rev. Rul. 76-103, 1976-1 C.B. 293.

155. *See* Rev. Rul. 76-103, 1976-1 C.B. 293.

156. *See* Estate of McNichol v. Commissioner, 265 F.2d 667, 670 (3rd Cir.), *cert. denied*, 361 U.S. 829 (1959).

facially subject. For example, in Revenue Ruling 76-103, after concluding that a gift in trust was not complete and would be subject to estate inclusion under IRC section 2038, the IRS noted:

> As long as the trustee continues to administer the trust under the law of State X [which permits creditors to reach trust property], the grantor retains dominion and control over the trust property. . . . If and when the grantor's dominion and control . . . ceases, such as by the trustee's decision to move the situs of the trust to a State where the grantor's creditors cannot reach the trust assets, then the gift is complete . . . .[157]

There is little indication in the IRS rulings that any detailed consideration would be given to potential arguments that a hypothetical creditor might assert in attempting to defeat the creditor protection purportedly offered under the laws of the jurisdiction selected by the settlor or trustee to govern the trust.[158] However, reliance on this silence as indicative of the transfer tax results applicable to a nonresident of a DAPT jurisdiction funding a self-settled trust may be presumptuous, absent a more specific revenue ruling involving transfer tax results under the new DAPT legislation when utilized by a settlor who is not a resident of the DAPT jurisdiction.

However, there is no indication that the IRS might take a more restrictive view than that espoused in Revenue Ruling 76-103, if confronted with a situation involving the new DAPT legislation and a non-DAPT jurisdiction resident settlor. In fact, the IRS has issued favorable Private Letter Rulings under both the new Alaska statute and the laws of an offshore jurisdiction, although such rulings should, at best, be viewed as insightful since they do not establish legal precedent upon which other taxpayer's might rely.[159] In both rulings, the IRS seemed to look solely to the rights of creditors under the law of the jurisdiction in which the assets would be administered and which was recited in the trust instrument as

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157. Rev. Rul. 76-103, 1976-1 C.B. 293.

158. The IRS has, at least on one occasion, given mention to an issue which might be raised where a non-DAPT state resident creates a trust to be administered under the laws of a DAPT, although the insight to be gained from this nonprecedential private letter ruling is limited, at best. *See* Priv. Ltr. Rul. 8829030 (Apr. 20, 1988). The IRS cited precedent from the law of the settlor's domicile which indicated that the law of the state in which the trust was administered would be applied in resolving legal issues concerning the trust. *See id.* On this basis the IRS applied the law of the state of trust administration to conclude that the settlor's creditors could not reach the settlor's interest in the trust, and thus that there would be no estate inclusion under IRC section 2038. *See id.* There was no discussion of any public policy or other reason to question that the law of the state of administration would govern.

159. *See* Priv. Ltr. Rul. 9837007 (June 10, 1998) (Alaska statute); Priv. Ltr. Rul. 9332006 (Aug. 20, 1992) (offshore self-settled trust). As to the precedential status of such rulings, see I.R.C. § 6110(j)(3).

governing the trust.[160] In the offshore context, the IRS ruled both that the transfer to the trust would be deemed a completed gift and the trust property would not be subject to inclusion in the settlor-beneficiary's gross estate under IRC section 2033 or IRC sections 2036-2038.[161] In contrast, in the more recent private letter ruling concerning an Alaska DAPT, the IRS expressly declined to rule on the estate inclusion issue.[162] Informal conversations with the author of the Alaska private letter ruling indicate that the discrepancy in results (or the IRS's willingness to rule) is not the result of anything specific about the laws of the jurisdiction at issue or any understanding at the IRS that OAPT assets may be less accessible to creditors. Instead, the more recent refusal to rule on the Alaska issue may best be construed as a tightening of IRS policy in this area since the date the offshore trust ruling was authored. The IRS's primary (albeit informally) stated concern in not ruling on the estate tax issue in the Alaska DAPT scenario was the possibility that an express or implied agreement may exist between the settlor and the trustee as to the settlor's retained interest in the trust, and that such an agreement would only be revealed by subsequently developed facts relating to the ongoing administration of the DAPT and distributions therefrom.[163]

Perhaps the most that can be said about the IRS rulings in this area is that they evidence the two most prevalent concerns about a transfer tax challenge based upon assets held in a self-settled DAPT—specifically, retained interest arguments based upon either the rights of the settlor's creditors to reach trust property, or the existence of an implied agreement concerning the settlor's continued enjoyment of trust property. That the

160. However, it should be noted that the Alaska ruling involved an Alaska resident, and thus the potential challenges to the applicability of Alaska law seem less significant, and therefore more easily ignored, than had the settlor been a non-Alaska resident. *See* Priv. Ltr. Rul. 9837007 (June 10, 1998).

161. *See* Priv. Ltr. Rul. 9332006 (Aug. 20, 1992).

162. *See* Priv. Ltr. Rul. 9837007 (June 10, 1998).

163. *See id.* The IRS has apparently stated this rationale similarly to others. *See, e.g.*, *Roundtable Discussion*, *supra* note 33, at 816 (Gideon Rothschild commenting upon his conversations with IRS author of the Alaska ruling). *See* Shaftel, *supra* note 38, at 57 (noting that counsel representing the Alaska donor indicated the IRS's belief that the estate issue was merely hypothetical at the time of the ruling, and, alternatively, that the IRS simply would not rule for policy reasons; Shaftel believes that a simpler explanation for the refusal was the implied agreement issue). The IRS author of the Alaska ruling has expressly stated to this author that the implied agreement possibility justified the IRS refusal to rule privately on the estate inclusion issue in the self-settled trust context—a possibility which need not be explored where inclusion is obviously dictated by virtue of creditors' rights in the trust property. *Compare* Priv. Ltr. Rul. 8829030 (Apr. 20, 1988) (refusing to rule under IRC section 2036 due to potential for implied agreement), *with* Priv. Ltr. Rul. 9646021 (Aug. 16, 1996) (stating the IRC section 2036 inclusion is based on creditors' rights in trust property under governing state law). For a discussion of this implied agreement issue, see Part VII.E.2., *supra.*

IRS will simply accept the choice of law stated in the trust instrument in the case of a nonresident of one of the DAPT jurisdictions is perhaps a reasonable conclusion to draw, but reliance on such a conclusion in a formal planning situation would seem risky at best, particularly if the planning arrangement is otherwise aggressive so as to merit significant IRS scrutiny. For example, if a self-settled DAPT were funded with entity interests upon which significant valuation discounts were taken for purposes of gift tax reporting, the IRS might be inclined to be aggressive in pursuing estate tax inclusion of trust assets if the valuation issue were first noticed in the context of an estate tax audit. This might be particularly true if the applicable statute of limitations for revaluing gifts had expired, such that the IRS lacked the ability to challenge the gifting transaction on the basis of excessive valuation discounts taken.[164]

E. *Transfer Tax Case Law*

There is adequate case law addressing the issue of a settlor's retained interest arising by virtue of creditors' rights and/or implied agreements as to the use of trust property for the settlor-beneficiary's benefit.[165] Such judicial opinions are revealing as to factors which an advisor should note in crafting a self-settled DAPT under the new domestic legislation, particularly with regard to the implied agreement issue. As to creditors' rights, the general principle of estate inclusion is not in dispute where such rights are clearly ascertainable. Thus, for example, where an Alaska resident-settlor establishes an Alaska spendthrift trust for the settlor's own benefit, there will likely be little issue as to creditors' rights under applicable state law, and thus there should be little likelihood of an estate inclusion dispute on this basis.[166] However, nonresident settlors seeking to take advantage of the self-settled spendthrift trust provisions of a domestic APT jurisdiction arguably face less certainty in this regard.[167]

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164. For the applicable statute of limitations for revaluing gifts, see I.R.C. §§ 6501(c)(9), 2504(c) (1996).

165. *See infra* notes 174-224 and accompanying text.

166. *See* Priv. Ltr. Rul. 9837007 (June 10, 1998). This is not to say, however, that if such a settlor were to incur a debt outside of the settlor's home state in a non-DAPT jurisdiction, a creditor would in all events be precluded from obtaining a judgment against the settlor-debtor in the jurisdiction in which the debt was incurred, and that such a judgment might purport to invalidate the trust transfers on the basis of the forum state's public policy, thus again raising the full faith and credit and jurisdictional issues discussed above. *See supra* Part V.B.2-3. It would seem, however, that the possibility of the results of a transfer tax case turning upon such a hypothetical scenario would be less for a resident settlor than in the case of a nonresident settlor. "Nonresident" as used here and in the text, *supra*, is intended to refer to a settlor who is not a resident of a state the DAPT laws of which the settlor seeks to take advantage.

167. See the discussion pertaining to the effectiveness of domestic APT legislation in Part VI, *supra*, and in particular the discussion concerning the potential complications arising when such

Unlike the Bankruptcy courts,[168] courts in tax disputes have not explored issues such as the validity of the settlor's choice of law provision or the possibility that the law of some other jurisdiction should apply such that creditors' rights would be broader than under the governing law stated in the instrument.[169] However, transfer tax cases have arisen in which the resolution of transfer tax issues turned upon state law creditors' rights which were not clearly defined in the self-settled trust context.[170] The courts' willingness in such cases to find for or against creditor rights—with the attendant transfer tax consequences—could be viewed as indicative of the courts' willingness to explore such issues in the more troublesome context of a transfer tax dispute involving a DAPT. Resolution of such issues in the context of a DAPT is likely to be more complex, however, since a result favorable to the IRS may turn upon the court's acceptance of the IRS's possible assertion that the DAPT jurisdiction's laws, stated as governing in the trust instrument, should be disregarded or are otherwise ineffective—such that the IRS prevails on a creditors' rights/settlor retained interest theory of estate inclusion. For example, such an assertion might be based upon the public policy of the state of the settlor-beneficiary's domicile at death if other than a DAPT jurisdiction, or the IRS could cite language in the governing DAPT statute which permits certain limited classes of creditors to recover against trust assets.[171]

Unfortunately, the results in the transfer tax cases to date are mixed with regard to indicating the likely level of scrutiny the courts might give to the various arguments which the IRS could proffer on behalf of a hypothetical creditor where estate tax inclusion of DAPT assets is at issue.[172] The tax court is seemingly more willing than other federal courts to find the existence of a retained interest in cases where the rights of

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weaknesses are called into question in a transfer tax dispute involving a hypothetical creditor.

168. *See, e.g.*, Sattin v. Brooks (*In re* Brooks), 217 B.R. 98, 104 (Bankr. D. Conn. 1998) (holding that spendthrift provisions set forth in Jersey (Channel Islands) and Bermuda trusts funded with property transferred by a U.S. debtor-beneficiary, were unenforceable under Connecticut law, which the court found to be applicable notwithstanding contrary choice of law provisions in the governing instruments); Marine Midland Bank v. Portnoy (*In re* Portnoy), 201 B.R. 685, 702 (Bankr. S.D.N.Y. 1996) (similar result and reasoning).

169. The question of applicable state law has certainly been addressed in tax court decisions (and obviously in those controversies considered by federal courts), although not in a context which would indicate any litigated dispute over this issue. *See, e.g*, Estate of Paxton v. Commissioner, 86 T.C. 785, 787 (1986) (noting simply that the "principal office of each of the[] trusts and the legal residence of each of the . . . trustees . . . were in the State of Washington. . . .").

170. *See, e.g.*, National City Bank v. Commissioner (*In re* Estate of Uhl), 241 F.2d 867 (7th Cir. 1957); Herzog v. Commissioner, 116 F.2d 591 (2d Cir. 1941) discussed in text accompanying *infra* notes 173-79.

171. *See supra* note 70 and accompanying text (discussing a provision in the Delaware legislation).

172. *See* Part VII.E.1., *supra*.

creditors are not altogether clear under state law. Such mixed results call into question the level of comfort available to a non- DAPT jurisdiction resident-settlor seeking transfer tax advantages under the laws of a DAPT jurisdiction, since by the IRS might similarly cloud the issue of creditors' rights by proffering various arguments as to the effectiveness of the DAPT legislation. Such arguments could, in turn, provide a court with sufficient leeway to reach an estate tax inclusion result which the court otherwise deems appropriate in light of the several factors which might influence the court's perception of the dispute.

However, there are specific actions which a settlor and the settlor's advisors might take to maximize the nexus between the DAPT jurisdiction and the trust, and otherwise to increase the likelihood that the desired transfer tax advantages would be upheld were the arrangement subjected to IRS challenge. In considering such actions, advisors must be mindful of the two most likely bases upon which the potential transfer tax advantages offered by a DAPT might be defeated—specifically, retained interest arguments based upon either the rights of the settlor's creditors to reach trust property, or the existence of an implied agreement concerning the settlor's continued enjoyment of trust property. Such matters, as well as the particular planner's acceptance of the various arguments posited above both for and against the effectiveness of the DAPT legislation, are likely to influence the planner's approach in advising clients as to the use of a DAPT for transfer tax planning reasons.

1. Creditors' Rights

An example of the courts' approach to a transfer tax challenge based upon retained interests via creditors' rights is the Seventh Circuit decision in *National City Bank v. Commissioner (In re Estate of Uhl)*[173] wherein the court found that state law did not clearly implicate the rights of creditors to reach trust property, and, thus, that estate inclusion by virtue of such creditors' alleged access to trust property was improper.[174] Although the Seventh Circuit and the tax court agreed upon the governing federal tax law principles of estate inclusion based on creditors' rights, the Seventh Circuit decision that creditors could not reach the trust assets under state law was a reversal of the tax court's holding, which was described by the Seventh Circuit as "based . . . upon the theory that the settlor's creditors, *by proper litigation, might have reached all of the corpus* . . . and that such a *possibility* constituted retention" by the settlor sufficient to result in estate inclusion.[175]

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173. 241 F.2d 867 (7th Cir. 1957).

174. *See id.* at 870.

175. *Id.* (emphasis added). While the Seventh Circuit's willingness to find against the

Similarly, in one of the earlier and most often cited cases in this transfer tax area, the Second Circuit in *Herzog v. Commissioner*[176] found a completed gift where creditors' rights under applicable state law were "in doubt" due to a lack of applicable precedent in the precise context of a self-settled trust.[177] The court opined that estate inclusion would not be appropriate.[178] In so concluding, the court noted the widely accepted Restatement principles in favor of creditor access to the trust property, but went out of its way to find the Restatement rule unpersuasive as to the hypothetical creditor's rights in the case at hand, citing the more real presence of remainder beneficiaries under the trust as significant.[179]

Although of less precedential value, the onus on the IRS to show that creditors could recover against the assets of a self-settled trust where state law is unclear is typified by the claims court case of *Estate of German v. United States*.[180] Like the courts in *Herzog* and *Estate of Uhl*, the claims court was willing to distinguish existing state law precedent, not directly on point as to self-settled trusts, to find that the IRS had failed to establish that the settlor's creditors could access the trust property.[181]

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hypothetical creditor is the interesting point to note about the approach taken in *Estate of Uhl*, there is some cause to question the Seventh Circuit's understanding of the consequences of its finding with regard to state law. The court incorrectly states that "such a right [in creditors to reach trust property], if it existed, was the right of the creditors, not that of the grantor." *Id.* The idea that such creditors' rights implicate rights in the decedent was more properly stated by the tax court in *Estate of Paxton*, where the court noted that

> [w]here the decedent at any time during his life could have obtained the economic benefit of the trust [property] by borrowing and then forcing his creditors to look to [his] interest in the trust [property] for a source of repayment, this interest has been held sufficient to require the inclusion of the transferred property in the decedent's gross estate under section 2036(a)(1).

Estate of Paxton v. Commissioner, 86 T.C. 785, 815 (1986).

176. 116 F.2d 591 (2d Cir. 1941).

177. *Id.* Interestingly, the courts of the state of New York (the laws of which were at issue in *Herzog*) later resolved this issue definitively in favor of creditors. *See Estate of Paxton*, 86 T.C. at 816 n.29 (discussing evolution of New York law on this point).

178. *See Herzog*, 116 F.2d at 595. This portion of the opinion with regard to estate tax consequences is arguably dicta, although the analysis and the court's approach to the unsettled issue of state law is not thereby lessened, since the estate and gift tax consequences turned on the same issue.

179. *See id.* at 594. The court believed the Restatement rule to be based in large part on decisions where the settlor beneficiary was the sole beneficiary, in contrast to the circumstance before the court in which there were other beneficiaries of the trust. *See id. But see* Estate of Uhl v. Commissioner, 25 T.C. 22, 25 (1955) (distinguishing *Herzog* based upon the lack of other trust beneficiaries in the case at hand), *rev'd*, 241 F.2d 867 (7th Cir. 1957). For the applicable Restatement rule, see 1 RESTATEMENT (SECOND) OF TRUSTS § 156 (1959).

180. 7 Cl. Ct. 641, 644-45 (1985).

181. *See id.* ("[T]he trusts here, but not in [the applicable state law case addressing creditor's

In contrast, the tax court in *Estate of Paxton*[182] took an approach which clearly cuts against any assumption that the absence of clear state law precedent on the creditors' rights issue would lead a court to find against the hypothetical creditor, and therefore in favor of a taxpayer seeking to exclude self-settled trust assets from the settlor's gross estate.[183] In *Estate of Paxton*, the rights of creditors—and the resulting estate inclusion or exclusion—under the law of Washington state were at issue.[184] Having already found estate inclusion proper under an implied agreement in this clearly abusive situation,[185] the tax court went on to consider whether estate inclusion was proper by virtue of the rights of creditors to reach trust property under state law.[186] Two Washington statutes discussed by the court seemed to clearly permit creditors to reach trust property.[187] The court nevertheless entertained the taxpayer's argument that the statutory provisions did not apply to the case at hand due to a lack of intent to defraud, and under that line of reasoning the court looked to Washington common law to discern the rights of creditors.[188] In what is arguably a direct contrast to the approach taken by the courts in such cases as *Estate of Uhl*, *Herzog*, and *Estate of German*, the court in *Estate of Paxton* concluded: "[w]e have found no cases . . . and petitioners [taxpayers] have cited none . . . suggesting that the courts of Washington would not follow the almost universally accepted rule of Restatement, Trusts 2d, sec. 156(2) . . . [that] decedent's creditors could reach the maximum amount which . . . could be distributed to him [from the trusts]. . . ."[189]

rights in the context of a deed of trust of which grantor was beneficiary] made dispositions of the property upon the death of the settlor and were not intended solely to shield her assets from her creditors.").

182. *See* 86 T.C. 785 (1986).

183. *See id.* at 820.

184. *See id.* at 801.

185. *See infra* Part VII.E.2., regarding estate inclusion under IRC section 2036(a)(1) by virtue of an implied agreement as to the settlor's continued enjoyment of trust property notwithstanding transfer of such property to a trust. The situation in *Paxton* seemed clearly abusive in that the settlor established and funded trusts, receiving in exchange for property contributed to the trusts "Certificates of Interest" representing his interests under the trusts. *See* 86 T.C. at 802 n.8. The taxpayer disputed a prior gift tax deficiency with respect to the transfers of property to the trusts (which trusts had other beneficiaries) by asserting that the taxpayer received something of equal value (the Certificates) in exchange for the property transferred to the trusts. *See id.* at 809. Yet, in the subsequent estate tax dispute, the taxpayer asserted that the trust interests should not be included in his estate because they had no discernable value in light of the discretion vested in the trustee. *See id.* at 802 n.8, 805, 809.

186. *See id.* at 818.

187. *See id.* at 816-18 (concluding that "[t]wo Washington statutes address this issue" and that under state law there was thus "an implicit recognition of the [Restatement] principle. . . .").

188. *See id.*

189. *Id.* at 818-19 (footnote omitted). As noted above, the court did find that Washington courts would likely follow the Restatement principles, as those principles were strongly implicated

A nonresident settlor having created a trust under the laws of a DAPT jurisdiction, but as to whom the laws of the settlor's domicile are more clearly implicated in creditor relations, might find a court similarly willing to resolve some of the questions concerning the effectiveness of a self-settled DAPT by reference to the Restatement rule and the public policy of the settlor's state of domicile. This is not to say that such an approach would be sound or even clear as to its implications concerning the actual practical access by creditors to the property held under a DAPT, but rather, that such an approach cannot be ruled out and would find some support in sources such as those relied upon by the tax court in *Estate of Paxton*.[190]

On the other hand, the tax court case of *Outwin v. Commissioner*[191] could also be viewed as demonstrative of a court's reluctance to speculate as to the rights of creditors for transfer tax purposes. In *Outwin*, however, it was the IRS requesting the court to find that a right in a remainder beneficiary to veto distributions to the settlor would *defeat* creditor claims under applicable state law, thus rendering the transfers to the self-settled

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by the two Washington statutes addressed by the court. *See id.* at 816-18. The cited Restatement section provides: "Where a person creates for his own benefit a trust for support or a discretionary trust, his transferee or creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit." 1 RESTATEMENT (SECOND) OF TRUSTS § 156(2) (1959).

190. *See* 1 RESTATEMENT (SECOND) OF TRUSTS § 63, cmt. b (1959) (if a person creates a self-settled trust "and the purpose of the settlor in creating the trust was to prevent his creditors, present or future, from reaching the property, the intended trust is invalid."); BOGERT & BOGERT, *supra* note 15, § 211 ("If a trust . . . has a purpose contrary to public policy . . . the courts will not permit the illegal objective of the settlor to be accomplished and will declare the trust void . . . or in the case of [specific violative] clauses, will strike [such clauses] and enforce the trust without regard [to such clauses]."); VA SCOTT & FRATCHER, *supra* note 96, § 598 ("There are situations in which the designation by the settlor of the governing law may be ineffective, even though he designates a state having a substantial connection with the trust [via, e.g., the trustee's domicile or the situs of trust assets]. On a particular issue of validity the ground for invalidity may rest upon such a strong policy of a state whose law would otherwise govern that the settlor would not be permitted to avoid the policy merely by designating another state as that of the controlling law."); *supra* note 85 and accompanying text. *But see id.* § 573 (containing the authors' further comment that: "In *Hanson v. Denckla* [discussed herein at note 88] the issue was as to the validity of the disposition of trust property. A similar question may arise as to the effect of a judgment rendered by a court [not having] primary jurisdiction [over the administration of the trust], giving instructions to the trustee as to his powers and duties or authorizing or directing the trustee to deviate from the terms of the trust. These matters are certainly ordinarily for the determination by the court that has primary supervision over the administration of the trust. Certainly in most cases the courts of . . . states [not having primary jurisdiction over administration of the trust] would decline to exercise jurisdiction . . . . If, however, such a court does exercise jurisdiction, the Supreme Court might well hold that the court of primary supervision is not bound to give full faith and credit to the judgment. Indeed, it might hold the judgment to be invalid even in the state that rendered it on the ground that it is an undue interference with the administration of the trust and a denial of due process of law.").

191. 76 T.C. 153 (1981).

trusts completed gifts.[192] In finding that creditors' rights were sufficient to render the gift incomplete notwithstanding the veto power, the court cited the strong public policy underlying the applicable state law against self-settled spendthrift trusts, which policy-based creditors' rights the court felt would not be defeated by the simple expedient of placing a veto power over distributions in the hands of a beneficiary with a potentially adverse interest.[193]

This approach could be seen as a willingness on the part of courts to examine the rights of a hypothetical creditor in detail for transfer tax purposes, but the better interpretation—at least of the cited cases—seems to be that, in general, some clear authority establishing the rights of creditors will be required before the transfer tax result of estate inclusion will be found.[194] Proponents of the planning opportunities presented by the DAPT statutes might argue more strongly that the cited cases show that where creditors' rights under the state law facially governing administration of the trust is clear, courts confronted with transfer tax issues will not speculate as to circumstances which might alter the state law result—and similarly, that where state law is unclear as to the rights of creditors, the courts will tend to find against creditor access to trust property.

Of course, in the transfer tax context of a DAPT, it is not state law, per se, as to creditors' rights that will likely be unclear (since the well-advised settlor will have stated in the instrument that the governing law is that of a DAPT jurisdiction), but rather, the key issue may be the validity of the settlor's choice of law provision as set forth in the trust instrument. If the settlor provides in the trust instrument that (for example) Alaska law governs, but such settlor resides in a non-DAPT state with a clear public policy against such creditor protection, a creditor action brought in such state of residence could find success if the resident state's courts refuse on public policy grounds to honor the choice of law provision. This issue, then, will turn upon considerations such as the public policy of the state in which the settlor resides—all of which would only be relevant should a

192. *See id.* at 166-67. For a discussion of the overlap between the gift and estate tax regimes, see *supra* notes 136-42 and accompanying text.

193. *See id.* It should be noted that it was the settlor's spouse who possessed the veto power, and there was a reciprocal trust situation likely to influence the spouse's willingness to exercise the veto power. *See id.* This arrangement clearly influenced the court's opinion as to the significance of the veto power.

194. The other reported decisions in this area seem to involve interpretations of state law, the applicability of which did not appear to be in dispute and which left little doubt as to the rights of creditors. *See, e.g.*, Paolozzi v. Commissioner, 23 T.C. 182, 186-87 (1954) (finding gift incomplete "[i]n view of the clear exposition of Massachusetts law" with respect to the right of creditors to access the trust property); Vander Weele v. Commissioner, 27 T.C. 340, 344-45 (1956) (having a similar result under Michigan law).

court hearing a transfer tax case decide to delve into such issues. Such a level of analysis would seem appropriate if raised by the IRS, since estate inclusion under this theory turns on the state law rights of creditors—an issue which cannot be resolved without first determining which state's law applies. If the settlor resides in one of the minority of jurisdictions having no stated public policy against self-settled spendthrift trusts, the transfer tax planning result would in all likelihood be the exclusion of trust property from the settlor's estate, since there would be little public policy basis for ignoring the choice of law provision in the trust instrument. Again, the fact that a transfer tax case would involve only a hypothetical creditor strengthens the likelihood of this result.

However, for settlors residing in one of the majority of states having a stated public policy against self-settled spendthrift trusts, it is entirely unclear what the result of a transfer tax case would be were the IRS to effectively call into question the issue of applicable state law. With other federal court authority such as *Portnoy* and *Brooks* analyzing the policy concerns which might overrule a settlor's choice of law with respect to an OAPT, it is not at all certain that the tax court or any other federal court confronted with an abusive transfer tax arrangement[195] would not proceed along similar lines to find on public policy grounds that, in the DAPT context, the relevant state law is that of the settlor's domicile, and that estate tax inclusion is therefore properly based upon that state's prohibition of self-settled spendthrift trusts. While the interpretation set forth above of the approach taken in cases such as *Herzog*, *Outwin*, and *Estate of Uhl* mitigates against such court speculation as to the rights of a hypothetical creditor, from a planning perspective there can be no certainty in this regard.

For transfer tax planning purposes courts should respect the settlor's choice of law as stated in the trust instrument, and courts should likewise respect the relevant creditors' rights provisions of such law. This is because for transfer tax planning purposes, a bright-line rule that can be counted upon at the planning stage brings certainty to the transfer tax planning process, and such certainty has *its own* public policy benefits completely separate from any negative policy concerns posited in the otherwise distinct creditors' rights context.[196] If the settlor of a DAPT complies with the requirements for creating a valid DAPT under DAPT

195. For an abusive transfer tax situation as to which it is likely the court would go through whatever level of analysis necessary to (rightfully) find against the taxpayer, see *Estate of Paxton v. Commissioner*, 86 T.C. 785 (1986), as to which the only true question seemed to be the rationale upon which estate tax inclusion would be found appropriate.

196. *See, e.g.*, VA SCOTT & FRATCHER, *supra* note 96, § 597 ("It would be fatal for estate planning if the validity of the trust or of a provision in the trust instrument should depend upon the local law of the state in which a suit might subsequently be brought. . . .").

statutes which impose a trustee and asset management nexus between the trust and the DAPT jurisdiction, it would not be unreasonable for courts in transfer tax cases to respect the settlor's choice of governing DAPT jurisdiction law and the creditors' rights provisions thereof. This is particularly true if the settlor relied upon the same logic in reporting transfers to the trust as completed gifts, based upon the DAPT jurisdiction's denial of creditor access to the transferred property once placed in the DAPT. The IRS would still be left with the implied agreement prong of its retained interest argument to challenge perceived abusive situations.

2. Implied Agreements

As noted above, the creditors' rights issue is not the only significant avenue of attack by which the IRS might challenge the exclusion of trust assets from the estate of a settlor-beneficiary. A second primary argument likely to be asserted, if the facts so warrant, is that there was an implicit arrangement between the settlor and the trustee (and perhaps the other trust beneficiaries) that the settlor would continue to enjoy the trust property notwithstanding the settlor's apparent right to such enjoyment only at the trustee's discretion. From a planning perspective, there are guidelines discernable from case law which can be followed to achieve some degree of insulation from such a finding.

As an initial matter, inclusion under IRC section 2036(a)(1) may result even though such an understanding is not expressly set forth in the trust instrument, and even though the understanding is not legally enforceable.[197] "All that is necessary is that the surrounding circumstances, particularly the manner in which the parties have dealt with the property, manifest the existence of an implied agreement."[198] Neither the reserved right to receive distributions in the discretion of an independent trustee, nor the actual receipt of trust distributions by the settlor-beneficiary, are alone sufficient to result in inclusion—some prearrangement must exist for the required

197. *See* Estate of Skinner v. United States, 316 F.2d 517, 519-20 (3rd Cir. 1963) (holding estate inclusion proper by virtue of prearrangement as to settlor retained enjoyment of trust property); Estate of McNichol v. Commissioner, 265 F.2d 667, 670-73 (3rd Cir. 1959) (holding property includible by virtue of oral agreement that transferor would retain income therefrom, regardless of whether such oral agreement was enforceable under state law); *Estate of Paxton*, 86 T.C. at 808 (agreement may be inferred); Estate of Green v. Commissioner, 64 T.C. 1049, 1061 (1975) ("[I]t is not necessary that the reservation be expressed in the instrument of transfer or even that it be legally enforceable. The statute also applies where the enjoyment has been retained pursuant to a contemporaneous arrangement or understanding in connection with or incident to the transfer.").

198. Estate of Whitt, 751 F.2d 1548, 1559 (11th Cir. 1985).

retained interest to be found.[199] Whether or not such prearrangement or understanding does exist is a question of fact,[200] and the burden is upon the taxpayer to disprove such prearrangement where the IRS asserts a deficiency on that basis.[201]

a. Pre-Transfer Discussions

To pass scrutiny under IRC section 2036(a)(1), the plan by which the self-settled DAPT is created must be designed and implemented without any oral or other understanding to the effect that the DAPT settlor will receive distributions upon request or otherwise as desired. While this may seem obvious, the planner must keep in mind that pre-transfer discussions between the settlor and trustee, or perhaps between the trustee and some other advisor or beneficiary having the ability to influence distributions to the settlor, may be revealed and prove detrimental to the settlor's estate should transfer tax litigation arise.[202]

b. Pre-Transfer Financial Analysis

Also in the realm of pre-transfer activities, perhaps the most important undertaking the planner should require is the preparation of a financial analysis designed to inform the settlor of the precise impact of the gift upon the settlor's personal cash flow. Even though one of the primary transfer tax planning benefits of the self-settled DAPT is the settlor's ability to remain a discretionary beneficiary of the DAPT while avoiding estate inclusion of the trust property, the financial analysis should be prepared as if the property were being given away without any retained interest whatsoever. This documented analysis is beneficial for several

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199. *See* Estate of Skinner v. United States, 197 F. Supp. 726 (E.D. Pa. 1961), *aff'd*, 316 F.2d 517 (3rd Cir. 1963); Estate of Wells v. Commissioner, 42 T.C.M. (CCH) 1305 (1981) ("[T]he triggering event of section 2036(a)(1) is not the mere receipt of income . . . ; some arrangement or understanding, and certainly not the mere inclusion of a provision allowing the trustee to distribute and the decedent to receive such income or corpus, is necessary for section 2036(a)(1) to apply.") (citations omitted); *Estate of Green*, 64 T.C. at 1061 ("The mere fact of receiving all the income from property previously transferred . . . does not of itself trigger the operation of section 2036(a)(1); there must have been a reservation of such enjoyment.").

200. *See* Estate of Schauerhamer v. Commissioner, 73 T.C.M. (CCH) 2855 (1997).

201. *See Estate of Whitt*, 751 F.2d at 1560; *Estate of Paxton*, 86 T.C. at 808; *Estate of Wells*, 42 T.C.M. (CCH) at 1305 (noting that the burden is a heavy one).

202. For example, in *Estate of Green*, the court found it irrelevant that the settlor-beneficiary herself never met personally with the corporate trustee, in light of discussions between the settlor-beneficiary's son/attorney and the corporate trustee at the time the corporate trustee agreed to serve. 64 T.C. at 1052. The court did find relevant the fact that distributions under the trust agreement, which were directed under the trust agreement to be made quarterly in the trustee's discretion, were changed from quarterly to monthly upon the settlor-beneficiary's subsequent inquiry as to why she was not getting her money. *See id.*

reasons. First, the settlor should have some minimum level of comfort that the transferred property is not essential to the continued maintenance of the settlor's standard of living.[203] In fact, several commentators have noted that from a strict asset protection standpoint, it is only a "nest egg" that should be transferred to the DAPT.[204] Second, such analysis will provide strong evidence that the settlor clearly understood and approached the transfer as one without any retained interest other than a mere expectancy, and that the distribution of property from the trust to the settlor-beneficiary was beyond any control or influence of the settlor. From a transfer tax perspective, this can be significant.

Demonstrative of these two reasons for conducting such a financial analysis is the court's decision in *Estate of Wells v. Commissioner*.[205] In that case, the IRS asserted that a proscribed prearrangement was evidenced by the settlor's receipt until her death of all of the income from a self-settled trust.[206] In rejecting this argument and finding in favor of the settlor's estate, the court emphasized that prior to making the transfer in trust, the settlor-beneficiary had specifically requested (and received) a financial projection showing how the absence of the property transferred to the trust would affect her remaining cash flow.[207] The financial analysis demonstrated to the court that the settlor clearly approached the transfer as a completed gift, and not as a retained interest transfer.[208]

In contrast, several courts have, on other facts, found an implied understanding that the settlor would continue to enjoy the trust property, where the reality of the settlor's post-transfer financial situation clearly revealed that the settlor could not reasonably have transferred the property without some clear understanding as to how the property would continue to benefit the settlor. *Estate of Paxton*[209] is one such tax court case in which the settlor—"a wealthy man accustomed to living well"—transferred most of his assets to self-settled spendthrift trusts, except for certain patent royalty rights which were set to expire by the time

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203. This comment should not be taken as contradictory to the discussion above concerning the DAPT as a vehicle which might help certain clients overcome a reluctance to part with property otherwise implicated as ideal for a gift and estate tax planning transfer. Rather, the above discussion posits that it is the possibility that property transferred to a DAPT *could* be utilized on behalf of the settlor which will often assist the client in resolving conflicting emotions about giving property away absolutely, without the possibility of receiving any future benefit from such property even in the most dire of circumstances.

204. CASNER & PENNELL, *supra* note 12, § 4.1.4; Engel, *in* DIAMOND, *supra* note 23, ¶ 1000.

205. 42 T.C.M. (CCH) at 1305.

206. *See id.*

207. *See id.*

208. *See id.*

209. 86 T.C. at 785.

the settlor reached age sixty-four.[210] The court supported its finding of an impermissible prearrangement by noting that:

> [w]e do not think he [the settlor] would have left himself virtually destitute at that age [of 64] without an understanding that he would receive the income or corpus or both from the trusts when and as needed . . . . [The settlor], in creating the trusts, was parting with virtually all he owned when his patent licensing agreements expired; he would hardly have risked giving up all his assets without making some arrangement to get some income or property back if and when he needed it.[211]

A third and perhaps equally important benefit to having a pre-transfer financial analysis which shows no significant detriment to the settlor's overall financial well-being is the potential that such fact will support the settlor's position should the trust's asset protection features be called into question. The financial analysis could be cited as evidence that the transfer was not fraudulent in that at the time of the transfer, the settlor retained ample assets to meet all but the most unexpected of contingencies. This could also be relevant to the planner assisting in the asset transfers should that planner's conduct be challenged as aiding the alleged fraud.[212] In addition, where the settlor resides in a state having an express public policy against self-settled spendthrift trusts, the financial analysis could be cited as evidence that the transfer at issue does not thwart the state's public policy because the settlor was not merely trying to remove assets from the reach of creditors while continuing to enjoy the benefits of the property. Since estate inclusion may follow creditors' rights in trust property, which in turn may depend upon the law deemed to govern the validity of the trust,[213] such arguments could prove particularly persuasive in the context of a transfer tax case where the IRS must argue on behalf of only a

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210. *Id.* at 810.

211. *Id.* at 810, 813 (citations and footnotes omitted). Other decisions demonstrate similar logic in reaching similar conclusions. *See, e.g.*, Estate of Green v. Commissioner, 64 T.C. 1049, 1062 (1975) (noting that settlor transferred approximately 85% of her assets to the trust and concluding "it seems highly unlikely she would have done so without some understanding that she would receive at least the comparatively modest amount of income generated by the transferred [assets] plus a portion of the corpus as well."). *Cf., e.g.*, Vander Weele v. Commissioner, 27 T.C. 340, 341 (1956) ("[The Settlor] expressed no desire to provide benefits for [the other trust beneficiaries] except in the event that a portion of the trust fund remained at her death, but spoke only of her purpose to ensure that she would have sufficient income to take care of her own needs for the remainder of her life.").

212. *See* CASNER & PENNELL, *supra* note 12, ¶ 4.1.4 n.42 (suggesting a series of disclosures and representations which an attorney should insist upon prior to undertaking any asset protection planning on behalf of that client).

213. *See supra* Part V.B.3. (discussing the choice of laws issues affecting DAPTs).

hypothetical creditor who has suffered no real injury as a result of the transfer.

c. Additional Trust Beneficiaries

The settlor's case against estate inclusion may also be strengthened by the presence of other trust beneficiaries. If those beneficiaries may also receive distributions during the settlor's lifetime, the settlor's arguments should be strengthened for many of the same reasons that a financial analysis indicative of a true gift might prove persuasive.[214]

d. Trustees

Selection of trustees and other "advisors" or persons having influence over whether the settlor-beneficiary receives distributions from the trust is another important planning factor. As to veto powers over distributions to the settlor or similar prerequisites to the settlor's receipt of trust distributions, that barrier alone will not prevent estate inclusion if the power-holder is subservient to the settlor's wishes.[215] As to trustees, the settlor's case should be bolstered if a clearly independent corporate fiduciary resident in the DAPT jurisdiction is selected. However, this fact alone will not preclude the finding of an implicit understanding as to the settlor's retained enjoyment of the trust property, as the courts have recognized that "[m]ost settlors would have no trouble finding a trustee friendly to his interests who could be counted on to honor [an] informal prearrangement to exercise 'absolute discretion' over income payments in favor of the settlor during his life."[216] Notwithstanding the apparent

214. This argument is, to some extent, deduced from situations where the court found that the property was properly includible in the transferor's estate due to the absence of other beneficiaries. *See, e.g.*, Guynn v. United States, 437 F.2d 1148, 1150 (4th Cir. 1971) (holding transferred real estate includible in decedent-transferor's gross estate under IRC section 2036(a)(1), and noting as "highly significant" the fact that donee's enjoyment of the transferred property was delayed until the transferor's death, which implicated the testamentary-like transfer policy underlying inclusion under IRC section 2036(a)(1)); *see also* Herzog v. Commissioner, 116 F.2d 591 (2d Cir. 1941) (presence of other beneficiaries deemed significant in context of creditors' rights under unsettled state law); Estate of Uhl v. Commissioner, 25 T.C. 22, 25 (1955) (distinguishing *Herzog* based upon the lack of other trust beneficiaries in the case at hand), *rev'd*, 241 F.2d 867 (7th Cir. 1957).

215. *See, e.g*, *Estate of Paxton*, 86 T.C. at 813 & n.24 (noting subservient family member trustee as fact weighing in favor of finding implied agreement); Estate of McCabe v. United States, 475 F.2d 1142, 1147 (Ct. Cl. 1973) ("it appears that the three parties [wife, settlor and individual trustee] at all times treated the decedent as having the right to receive the trust corpus, exercisable on the mere formality of his wife's demand.").

216. Estate of Skinner v. United States, 197 F. Supp. 726, 730 (E.D. Pa. 1961). The district court decision in *Skinner* was affirmed by the Third Circuit, which similarly noted that "every case of this sort must stand on its own facts and . . . the practice of assuming that a trustee, corporate or otherwise, is necessarily independent of the [settlor-beneficiary] whom he represents, need not be

independence of a trustee, therefore, the actual administration of the trust will be an important factor in finding for or against the existence of an implied agreement.[217]

e. Trust Distributions

As noted above, mere receipt of distributions from the trust will not alone result in a finding of an implied agreement.[218] However, the case law is somewhat mixed as to the significance of the settlor's receipt of distributions, and the most reasonable conclusion would seem to be that receipt by the settlor of all trust income or of income at regular intervals or in regular amounts, would weaken the settlor's argument that there was no implied understanding as to the settlor's retained enjoyment.[219] Indeed, absent a drastic change in the settlor's financial situation—the fear of which may have motivated the use of a DAPT instead of a non-DAPT irrevocable trust to begin with—distributions to the settlor from the trust run counter to a true gift tax planning strategy by denying such distributed amounts (and appreciation thereon) to the non-settlor beneficiaries, and because the distributed amounts may ultimately be included in the settlor's gross estate by virtue of the settlor's unfettered possession of such amounts at death.

On the other hand, it should be permissible to include a standard guiding the trustee's discretion as to distributions to the settlor, so long as that standard may not be enforced by the settlor so as to require that a distribution be made to the settlor.[220] An "absolute discretion" standard is

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followed invariably, but may be rebutted by circumstances." 316 F.2d 517, 520 (3d Cir. 1963).

217. *See Estate of Skinner*, 197 F. Supp. at 730.

218. *See, e.g.*, Estate of Wells v. Commissioner, 42 T.C.M. (CCH) 1305 (1981) (holding estate inclusion was not proper despite settlor's receipt of all trust income during her lifetime).

219. *Compare id.* (holding trust property not includible under IRC section 2036(a)(1) despite receipt by settlor of all trust income in discretion of her trustee-son), *with Estate of Paxton*, 86 T.C. at 811-12 ("However, continuous receipt of substantial amounts of trust income is not necessary to support the finding of a prearrangement under section 2036(a)(1)."). In this regard, see also *Estate of Skinner*, where the court stated in connection with its holding that a prearrangement existed and thus property was includible under IRC section 2036(a)(1):

> The holding here does not necessarily cover facts where, in the exercise of the trustee's "discretion," the settlor has received the entire income for life but there is no evidence from which any prearrangement can be inferred; or where the settlor has received only part of the income from the trust property, and at irregular intervals and in irregular amounts, or under any other circumstances in which the election of the trustee to pay income regularly to the settlor apparently was not foreordained at the time of the execution of the trust.

197 F. Supp. at 730.

220. *See* BITTKER & LOKKEN, *supra* note 123, ¶ 126.6.4 (discussing in the context of IRC

therefore the recommended approach, although the settlor might feel more secure by including in the trust instrument a non-ascertainable standard to which reference could nevertheless be made in the event the settlor were later to become destitute.

f. Trust Administration

Finally, the *formal* arrangement, which should be designed to avoid estate inclusion, must itself be honored in the actual administration of the trust. The trustee should make adequate investigation of beneficiary circumstances prior to making distributions, or at least have some discernable criteria for making distributions in order to avoid the implication that distributions were made simply at the settlor's command.[221] Similarly, and of particular relevance where family members or other subservient trustees are utilized, the formalities of the trust arrangement should be meticulously respected.[222]

g. The Bottom Line

The foregoing considerations indicate that the likelihood of estate inclusion under IRC section 2036(a)(1) by virtue of an implied agreement can be adequately addressed through careful pre-transfer planning and independent post-transfer administration. Some of the planning implicated in this regard—such as a pre-transfer financial plan—may also enhance the settlor's argument that the governing law stated in the instrument should control, and, therefore, that inclusion under the creditors' rights theory of IRC section 2036 or section 2038 would be improper. However, while the implied agreement concept can be fairly effectively dealt with from the outset—and thus some degree of certainty assured[223]—the use of a DAPT for transfer tax planning by a nonresident of the DAPT jurisdiction is currently uncertain given the concerns about the level of creditor protection actually afforded by a DAPT and uncertainty as to the depth of the creditors' rights analysis likely to be applied by a court considering a transfer tax dispute but having before it only a hypothetical creditor.

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section 2036(a)(1) the transferor's right to income under a standard which may be asserted to compel a distribution to the transferor, and those which might not be so enforced).

221. *See, e.g.*, Estate of McCabe v. United States, 475 F.2d 1142 (Ct. Cl. 1973) (clear that distributions were made to settlor's wife/trust beneficiary and deposited in settlor's account, all at settlor's command and without regard to distribution standard stated in instrument).

222. *See, e.g.*, Estate of Schauerhamer v. Commissioner, 73 T.C.M. (CCH) 2855 (1997) (with the knowledge of and without objection by other partners, decedent commingled partnership funds with her own for her personal use).

223. *See supra* notes 198-202 and accompanying text (regarding the factual nature of this inquiry).

VIII. CONCLUSION: POLICY QUESTIONS ABOUND

The purpose of the foregoing discussion is to address the extent to which the recent advent of domestic asset protection trust legislation impacts transfer tax planning. Although questions abound concerning the effectiveness of such domestic legislation in shielding assets from the claims of the settlor's creditors, no less significant are the transfer tax planning ramifications of the potential for a completed gift of property with retained lifetime discretionary enjoyment of the gifted property, without inclusion of such property in the transferor's gross estate at death. The true extent to which the transfer tax planning dynamic has or will be affected is likely to be further influenced by policy issues that necessarily permeate any consideration as to what the new domestic statutes mean (or should mean) to wealthy individuals and the financial and legal communities. Putting aside for the moment the obvious policy questions of whether such asset protection is desirable or should be permitted at all—since such protection will continue to be available offshore notwithstanding domestic policy concerns—the now available domestic APT raises additional significant policy issues at both the state and federal level.

A. *Transfer Tax Policy Issues*

The merits of considering the use of a DAPT in connection with a wealth transfer plan is to some extent enhanced by a simple policy argument. Specifically, with respect to the likely depth of court analysis of the creditors' rights issue in a transfer tax dispute, Treasury concerns over the growth of offshore trust arrangements should compel the IRS to avoid any arguments that favor OAPTs relative to DAPTs.[224] For example, if the IRS is confronted with a settlor who previously paid gift taxes upon funding a DAPT, and if there is no evidence of an implied understanding that the settlor would continue to enjoy trust property during the settlor's lifetime, the IRS would be ill-advised to pursue estate inclusion of DAPT assets based upon the conceivable range of potential creditor challenges to the effectiveness of the domestic legislation in actually shielding trust assets from creditor claims. This is because in the hypothetical creditor context, there are simply more bases upon which the creditor protection offered by a DAPT might fail relative to those upon which an OAPT might fail. For example, the full faith and credit and other potential U.S. Constitutional challenges to DAPTs cannot be raised by the IRS in a case involving an OAPT. Exploitation of such additional DAPT weaknesses by the IRS would thus facilitate a DAPT-OAPT disparity in a manner that is inconsistent with Treasury concerns about the offshore trust industry.

224. *See supra* notes 27-34 and accompanying text.

Moreover, the IRS always has the option of pursuing estate inclusion based on the implied agreement analysis discussed above, should the IRS view a situation as abusive.[225]

On the other hand, should the IRS choose to argue for estate inclusion with respect to assets held in either a DAPT or OAPT based on the creditor protection issue, it would not be unreasonable for a court to find estate inclusion proper where a deceased settlor-beneficiary resided in and maintained significant contacts with a jurisdiction having an express public policy against self-settled spendthrift trusts. The court might simply note authority establishing the resident state's public policy, cite (for example) *In re Portnoy*[226] and the Restatement rule to find that the trust would not be recognized as valid by the state of the settlor's domicile at death,[227] and therefore hold that for transfer tax purposes creditors will be deemed able to reach the trust property such that estate inclusion is proper. An IRS argument to this effect could be pursued with equal aggressiveness against both DAPTs and OAPTs, since the same rationale could invalidate either type of trust on the basis of the public policy of the state in which the settlor resided at death. Moreover, this line of analysis arguably recasts the OAPT-DAPT disparity into a disparity between trusts in which the settlor remains a beneficiary versus the more traditional irrevocable trust under the terms of which the settlor is completely excluded as a beneficiary.

Nevertheless, pursuing such an argument might be risky for the IRS. Specifically, the higher likelihood of a non-APT forum state's courts having jurisdiction over a DAPT trustee and trust property relative to an OAPT trustee and trust property, may once again put the IRS at a disadvantage from the policy standpoint of seeking estate inclusion of DAPT assets such that a disparity between OAPTs and DAPTs is created.[228] This is because at some point a court may acknowledge that the creditors' rights rationale for estate inclusion of trust property should entail practical availability of such assets to satisfy creditor claims, and

225. *See* Part VII.E.2., *supra* (discussing the implied agreement analysis); *see also* Marty-Nelson, *supra* note 5, at 443 (suggesting implied agreement analysis as possible view of OAPT estate tax inclusion issue).

226. 201 B.R. 685 (Bankr. S.D.N.Y. 1996).

227. *See supra* Part VI.B.3, note 6 and accompanying text. At least one other commentator has suggested that other states should recognize the Alaska and Delaware statutes as valid, since such recognition would likely keep more assets onshore, rather than offshore in potential tax haven jurisdictions. *See Roundtable Discussion*, *supra* note 33, at 796 (comments of Gideon Rothschild). In addition, Marty-Nelson, *supra* note 5, at 442-45, should be consulted with respect to options for "equalizing domestic and foreign trusts," although that commentary was proffered prior to the new domestic legislation and at a time when only offshore trusts were believed to offer self-settled asset protection.

228. *See supra* notes 97-112 and accompanying text (discussing the issue of personal and *in rem* jurisdiction).

jurisdictional concerns alone favor the practical availability of DAPT assets over those held in an OAPT. For example, where creditor recovery is expressly precluded under the APT jurisdiction's laws, a non-APT forum court's jurisdiction over the trustee and/or trust property would seem to be a prerequisite to creditor recovery (and therefore estate inclusion), and such jurisdiction is more likely to be established in the case of a DAPT having a domestic trustee. Consider in this regard an estate tax dispute arising under the facts of the *Portnoy* case[229] subsequent to the Bankruptcy Court's holding that trust assets were not immune to creditor claims under what the court found to be the non-APT jurisdiction's governing law (which differed from the governing law stated in the trust instrument). If the trust at issue were an OAPT and the OAPT assets were of unknown character due to the court's inability to compel disclosure by the offshore trustee over which the court lacked jurisdiction, the settlor's estate could argue in the transfer tax dispute that estate inclusion is improper because (i) the settlor's creditors cannot actually reach the OAPT property due to the bankruptcy (or other forum) court's complete lack of jurisdiction over the OAPT trustee or its assets—i.e., the touted creditor protection is real; and therefore (ii) the court should base its transfer tax decision on *actual* creditor's rights as demonstrated by practical considerations inherent in the governing law under which the trust was administered throughout the settlor's lifetime. Such practical considerations would likely be lacking in the case of a DAPT, since the bankruptcy court would clearly have jurisdiction to enforce its judgment against any domestic trustee upon finding on conflicts of law and public policy grounds that the trust did not preclude creditor recovery against trust assets. Should the IRS succeed in a transfer tax challenge involving a DAPT, and should the court mention either the non-APT state's or the bankruptcy court's jurisdiction over trust assets and trustees as relevant in the estate inclusion determination, the IRS will have essentially demonstrated another potential advantage of going offshore. If such jurisdiction is deemed relevant in a reported decision, and if such jurisdiction can clearly be thwarted in the case of an OAPT more easily than in the case of a DAPT, the transfer tax disparity may again be recast as one of OAPT/traditional irrevocable trust versus the DAPT. Still, the foregoing lines of reasoning to some extent seem to depart from the level of scrutiny employed by the courts on behalf of a hypothetical creditor in transfer tax cases.

However, none of those transfer tax cases address a bona fide choice of law dispute such as that raised in *In re Portnoy*. The point is, there is an uncertain degree of security in planning for transfer tax advantages

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229. 201 B.R. 685 (Bankr. S.D.N.Y. 1996), discussed at *supra* notes 102-21 and accompanying text.

potentially available to a DAPT settlor residing in a jurisdiction which has not disavowed the generally accepted public policy invalidating self-settled spendthrift trusts, and this uncertainty limits—but does not defeat at the client's option after careful disclosure—the potential utilization of a DAPT in connection with a wealth transfer plan. Any IRS approach to an estate tax situation involving a DAPT, other than complete acquiescence on the creditors' rights issue, raises multiple policy questions which may ultimately shape the transfer tax parameters of planning with a DAPT.

B. *State Policy Dilemma*

That Alaska and Nevada have provided more narrow protection for spouses and dependent children than has Delaware raises an interesting public policy dilemma for current non-DAPT states, and particularly those states which desire to compete in the APT market but not at the cost of all public policy concerns thereby raised. Specifically, it would seem that states reevaluating the policies underlying the self-settled spendthrift trust prohibition must choose between: (1) strengthening laws which favor *creditors* pursuing claims against resident settlor-beneficiaries of a DAPT formed under the laws of and located in a different jurisdiction; or (2) wholly abandoning the prohibition against self-settled spendthrift trusts, with little or no public policy exceptions for particular classes of creditors.

Strengthening the self-settled spendthrift trust prohibition, and the policy expressions and creditors' rights relating to such trusts, would be a prudent course of action for any state not wishing to compete in the APT market, because both DAPT and OAPT challenges will inevitably arise in such states as the prevalence of such trusts grows.

In contrast, a partial effort to compete—by, for example, enacting DAPT legislation which includes more public policy-based creditor exceptions than provided for under Alaska's statute—could prove very counter-productive. This is because residents of any state permitting DAPTs but falling short of the Alaska debtor-friendly standard might take their trust business out-of-state to Alaska. In such circumstance, the settlor's domiciliary state will have provided an added benefit to its resident-settlor by eviscerating the general public policy arguments for invalidating the Alaska spendthrift protection, in light of the settlor's domiciliary state having rejected generally the public policy against self-settled spendthrift trusts.[230]

230. It seems this dilemma may have to some extent played itself out in the context of the Alaska-Delaware duel to become the leading trust jurisdiction. Specifically, Delaware has already amended its trust act to delete one stated exception which would have permitted creditors to invalidate the trust to the extent the extension of credit was made in reliance on representations by the settlor as to the availability of trust assets. *See* Nenno, *supra* note 40, at 3 (noting this

As an example of the foregoing dilemma, consider a Delaware resident who establishes a DAPT utilizing the potentially more protective Alaska legislation to provide for Alaska trustees, administration, and situs. General third-party creditors (i.e., not a dependent child or spouse) seeking to invalidate the settlor's Alaska DAPT would likely pursue their claims initially in the Delaware courts, since that is where the settlor remains domiciled and where significant contacts with the creditor relationship are likely to be the strongest. Public policy arguments proffered to the Delaware courts by the creditor as grounds for invalidating the Alaska DAPT should fail. This is because the basic public policy of the Delaware (that is, the forum state) would, for purposes relevant to the general creditor, seem to be in accord with the public policy of Alaska (i.e., the state the laws of which were chosen by the debtor-settlor to govern the validity and operation of the DAPT), since the Delaware and Alaska trust legislation are very similar in the protection afforded settlor-beneficiaries against the claims of general third-party creditors. Thus, by attempting to compete but at a level less debtor-friendly than Alaska, Delaware has potentially abandoned its former public policy against self-settled spendthrift trusts, but to little competitive avail given the other APT options available to the settlor seeking the highest level of domestic asset protection. Moreover, it seems that Alaska's more limited *enunciated* exceptions to its DAPT legislation should translate into a more favorable resolution of any transfer tax dispute relating to a settlor's retained interest in an Alaska DAPT, since a court's analysis in a transfer tax dispute might very well end after a cursory analysis of the Alaska statute posited under the trust instrument as governing creditors' rights.[231]

The possible consequence of this dilemma could be either (1) states following Alaska's lead wholeheartedly so as not to be perceived as weaker in the competitive environment for asset protection; or (2) states acting against a loss of resident business by more pointedly enunciating public policy mandates against self-settled spendthrift trusts, perhaps even going so far as to amend conflicts of law rules which might otherwise result in the law of Alaska (or a similar APT jurisdiction) being held to govern a creditors' right to DAPT trust property in an action brought in that amending state's courts.

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amendment but without analysis—but also opining that the Delaware "exception for alimony, child support, and property division is an exception that would almost certainly exist even if it were not in the statute because it is highly unlikely that any court in the U.S. would permit a child to go without support while the settlor/parent was living—perhaps very well—on funds received from a retained interest in trust.").

231. The thought being that such a dispute most likely would turn upon the IRS arguing on behalf of the rights of a hypothetical creditor, and in that regard focusing upon the hypothetical dependent spouse or child as creditor, the rights of which could result in estate inclusion.

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 tax planning seminars if DAPTs were to go the route of LLCs—receiving a clear IRS blessing of general applicability and suddenly becoming the norm in all U.S. jurisdictions.