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Wealth Management

Being Your Own Beneficiary

Does a self-settled trust actually work for its intended purpose of estate tax exclusion?

By Anthony F. Vitiello

A 63-year-old widow sees you for an initial client meeting. Her husband was a successful businessman, starting a consulting company 30 years ago. He worked hard, with many late nights. She raised their three children, managed the household and their lives. The business blossomed. Five years ago, he sold the business. They had accumulated significant assets over their 35-year marriage. She has eight young grandchildren. Life was great, until two years ago, when her husband suddenly died.

The couple had simple wills, prepared long ago. She currently has $8 million in her investment account, a home and a beach house.

Financial planners have advised your client that she should undertake a gift-planning regime, given her likely estate tax burden. She had also been counseled to obtain an insurance policy with a large death benefit. However, she has had some medical issues; while amenable to funding a lower premium policy, she would not purchase the recommended amount. More importantly, she fears giving away her assets, believing she would be left with little security to live her life; regardless of her health issues, she could certainly live to the age that her mother is and grandmother was at her death. Your client was adamant about the security issue, although she trusted her children implicitly and she knew the estate tax would hurt her family's security.

On your advice, she accedes to two qualified personal residence trusts. She also agrees to fund a life insurance trust with a $30,000 annual premium. She accepts none of your other ideas, such as a trust for annual gifts, a grantor retained annuity trust and a family partnership. To her, all those tools mean a complete parting with her assets. The financial planning analyses she has shared with you, as well as your own review, indicate that she will never exhaust her assets; her problem will compound over time.

Given her hesitancy, you indicate that there is a type of trust that may receive completed gifts from her (using advanced planning techniques), and could pass on to her children (in trust or otherwise) upon her death, without being included in her estate. The difference between this "self-settled" trust and a typical trust used in estate planning is that your client is a discretionary beneficiary of the self-settled trust. Her eyes light up. She asks if one of her children can be a trustee. You indicate it is possible. You also inform her that the trustees could decide to make or not make distributions to her, in their complete discretion. Furthermore, you caution that while the theory on the estate tax exclusion seems promising, there is no authority directly on point. She also must avail herself of another state's trust laws since the laws of her home state would cause a self-settled trust's assets to be included in her gross estate. After you explain additional risks, she directs you to help her establish a self-settled trust. This structure has placated her fears. She understands the tax risks.

Does the trust actually work for its intended purpose of estate tax exclusion?

Section 2036(a)(1) of the Internal

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Revenue Code (IRC) includes in the gross estate assets gifted by the decedent (in trust or otherwise) if she retained "the right to the income from" or "the possession or enjoyment of" such assets for life. In the posited design, the client has no *right* to income or principal. So the key question in the Section 2036 analysis is whether the client retains "possession or enjoyment of" the property for her life.

Similarly, the Internal Revenue Service (IRS) can also raise Section 2038 as a possible avenue of gross estate inclusion if the grantor-beneficiary retained the right to alter, amend, revoke or terminate the trust at death. But in the present design, no such power exists; the grantor has retained no power over the trust or trust property.

The question of estate tax inclusion of the proposed self-settled trust rests on the legal definition of "possession or enjoyment of" trust property. But where in this example is the retention of possession or enjoyment by the grantor? The question hinges on whether creditors of the grantor can access the trust assets to satisfy claims against the grantor. Case law and IRS releases have held that if a governing jurisdiction's law allows the creditors of a settlor to attach a self-settled trust's assets, then the settlor has retained possession or enjoyment of the trust assets. See e.g. *Estate of Wells v. Commissioner*, T.C. Memo 1981-574. IRS Rev. Rul. 76-103; IRS Technical Advice Memorandum (TAM) 199917001. However, case law and IRS releases have also held that when the governing law does not allow a settlor's creditors to attach such a fully discretionary self-settled trust's assets, the trust is not included in the settlor's estate for federal estate tax purposes. IRS Private Letter Ruling (PLR) 8037116; PLR 9332006; IRS PLR 933206; *Estate of German v. U.S.*, 7 Cl.Ct. 641 (1985). (PLRs and TAMs may not be cited as authority and only apply to the person requesting the ruling; but the IRS' analysis is instructive.)

In most states, self-settled trusts are subject to creditor claims of the person creating the trust. See e.g. NJSA § 25:2-1; NJSA § 3B:11-1; McKinney's EPTL § 7-3.1. Thus, in most states, the design would not achieve the intended result.

Some states, apparently looking to promote increased business activity from trust services, amended their trust laws, in part, in an attempt to achieve estate tax exclusion. The states sharing most of the limelight are Delaware and Alaska.

Taking Alaska and Delaware as examples, how do these states prohibit creditors from attaching trust assets contributed by a settlor to a self-settled trust? Both states have fraudulent transfer laws that would unwind a transfer to the trust if certain elements of the statutes are met. But these laws are apparently not crucial in the analysis since: (i) one might analogize such rules to an outright gift to a child or a non-self-settled trust in violation of such fraudulent transfer laws; and (ii) at the very most, there is a finite time limit on the ability to prosecute a fraudulent transfer (at least in Alaska), thus taking the issue out of most of the timing provisions of Section 2036. The governing jurisdictions in the IRS releases and case law approving estate tax exclusion of self-settled trusts most certainly had some form of fraudulent transfer laws that should have been considered if relevant to the Section 2036(a)(1) analysis.

Other than fraudulent transfers, Delaware's Qualified Dispositions in Trust Act prohibits creditors of a settlor of a fully discretionary trust from reaching self-settled trust assets with two exceptions: 1) claims resulting from an agreement or court order for certain alimony obligations, child support or marital property settlements; or 2) certain tort creditors where the damage occurs prior to the creation of the trust. The issue raising the most concern is the ability of a court to invade a Delaware self-settled trust for certain alimony obligations, child support or property settlement claims. One view is that these claims are not truly "creditor" claims as contemplated under state law and the authorities relating to Section 2036(a)(1). However, each planner must judge the merits of such an argument.

Other than its standard fraudulent transfer laws, Alaska has one exception to the general rule that creditors of a settlor cannot access a self-settled trust: if the grantor is in default at least 30 days in making a payment under a child support order when the trust is created, the trust can be accessed to satisfy that claim. In sum, under Alaska law, as long as no delinquent child support obligation exists at the time of the creation of the trust (or the transfer to the trust), there is no creditor access.

So how does a client from New Jersey obtain the benefits of the proposed Alaska or Delaware self-settled trust? As for Alaska, there are four basic requirements. First, there must be a qualified Alaska resident trustee (an Alaska resident individual, an Alaska trust company or an Alaska bank). Second, at least some of the assets must be deposited in Alaska. Third, the Alaska trustee must maintain trust records and prepare or arrange for the preparation of a fiduciary income tax return (if required). Finally, at least part of the administration of the trust must occur in Alaska, including physically maintaining trust records in the state.

Most of these requirements are easily met, including the retention of an Alaska trustee. In addition, Alaska law can allow for the segregation of duties that can relegate the Alaska resident trustee to merely an administrative role while giving another trustee management of virtually all assets, investments and distributions. Alaska corporate trustee fees can be relatively reasonable and the scope of the assets that must be deposited in Alaska may be relatively small.

As for Delaware, the trust must have a spendthrift clause, provide that Delaware law governs the trust and appoints at least one Delaware trustee (either a resident individual or a corporate entity authorized to conduct trust business in Delaware). Some trust property must be custodied in Delaware, trust records must be maintained in Delaware and the Delaware trustee must prepare or

arrange for the preparation of the trust income tax returns. In sum, the requirements are similar to Alaska's requirements.

Will New Jersey courts be required to respect the structure even though it statutorily permits creditors to access self-settled trusts? While the answer is not certain, there are two cases that provide guidance. The first is *Hanson v. Denckla*, 357 U.S. 235 (1958). In *Hanson*, the Supreme Court refused to give a Florida court's judgment full faith and credit against a Delaware trustee based on the fact that the Florida court had no jurisdiction over the Delaware trustee or the Delaware trust. The settlor of the trust was domiciled in Florida at the time of her death and she was not domiciled in Delaware when she created the trust.

The second case is *German v. US*, 7 Cl.Ct. 641 (1985) in which the Court of Claims held that under Maryland law (the law applicable to the trust), there was no right to access the self-settled trust by the settlor's creditors; thus Section 2036(a)(1) did not apply to include the assets in the estate of the settlor. Although not clear from the opinion, and not relied upon, it is believed that the settlor in *German* was not a resident of Maryland at creation of the trust or at the death of the settlor; instead, the only reason that Maryland law applied was that there was a Maryland trustee and the trust instrument chose Maryland as the governing law. While these two opinions leave plenty of room for disagreement as to whether the client's home state will be forced to respect foreign trust provisions, the opinions do indicate that such a structure is possible and analogous facts have been respected in the past.

There are also other issues that must be considered, most of which are too numerous to name herein. One important issue is the choice of the trustee who handles all substantive issues. Will simply giving the foreign trustee administrative powers and choosing another trustee to handle all substantive issues work? Can that other trustee be a child? It appears that a child with a beneficial (i.e. adverse) interest in the trust would help, at least in the view of the Court of Claims in *German*, since the court relied heavily on the need for a beneficiary with an adverse interest to approve distributions to the settlor.

Another consideration is whether to give the settlor a right to remove and replace trustees with unrelated or nonsubordinate parties, in accordance with IRS Revenue Ruling 95-58; while such a power on its own does not cause gross estate inclusion, it may be a more conservative approach to design the self-settled trust with a "protector" who is given the power to remove and replace trustees, independent of the settlor. Finally, the states with favorable self-settled trust laws do have various technical differences that must be weighed. For example, there are differing views on the tax implications of varied forms of the rule against perpetuities repeal in these states and the tax effect on later generations.

In sum, self-settled trusts established for estate tax exclusion purposes have significant potential benefits but also have risks. In the appropriate circumstance, the situation may call for the assumption of those risks in order to implement some semblance of an estate plan. While by no means should this be the first option, sometimes, either the client or the circumstances give the planner no other choice. ■