The Estate and Gift Tax Implications of Self-Settled Domestic Asset Protection Trusts: Can You Really Have Your Cake and Eat It Too?

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THE ESTATE AND GIFT TAX IMPLICATIONS OF SELF-SETTLED DOMESTIC ASSET PROTECTION TRUSTS: CAN YOU REALLY HAVE YOUR CAKE AND EAT IT TOO?

PHYLLIS C. SMITH*

Abstract: Self-settled asset protection trusts are wealth preservation trusts coupled with the spendthrift provisions. This type of trust permits the settlor to have the benefit of treating the trust as a separate entity thereby protecting his assets from creditors while maintaining a pecuniary interest, as well as some level of control over what ultimately happens to the trust property. By providing asset protection from potential creditors while still having the ability to maintain a beneficial interest in the trust, the settlor can essentially “have his cake and eat it too.” The typical domestic self-settled asset protection trust may not be treated as an asset of the settlor for creditor claims. Whether these assets should be treated as owned by the settlor for the purpose of inclusion in the gross estate of the decedent for estate tax purposes is the focus of this Article. The author asserts that it is appropriate to include certain property settled in a domestic asset protection trust (“DAPT”) in the settlor’s gross estate for estate tax purposes because of the control the settlor retains over the trust assets up until his death.

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“If government have a right of demanding ad libitum and of taxing us themselves to the full amount of their demand if we do not comply with it, this would leave us without anything we can call property.” Thomas Jefferson

INTRODUCTION

The phrase, “you can’t have your cake and eat it too,” in its original form, intended to provide a deeper message about life, not dessert. Simply

2. The original phrase, “[w]olde ye bothe eate your cake, and haue your cake?” is attributed to John Heywood and was recorded as early as 1546. THE YALE BOOK OF QUOTATIONS 614 (Fred R. Shapiro ed., 2006) (quoting JOHN HEYWOOD, DIALOGUE OF
put, you cannot have it both ways; you can either keep the cake or eat the cake. For once you have eaten the cake, the cake is gone, so it is not possible to then still have (possess) the same cake. In recent years, some states have enacted legislation designed to permit certain propertied persons to essentially have it both ways. These legislative acts permit property owners to transfer certain property to irrevocable trusts, known as self-settled asset protection trusts (“APTs”). These trusts are designed to protect trust property from certain creditor claims and still permit the settlor to maintain an interest in the trust.\(^3\)

APTs are wealth preservation trusts coupled with spendthrift provisions to protect the settlor’s assets from future creditors.\(^4\) A self-settled APT is a spendthrift trust created by the settlor to provide a benefit to himself as well as other beneficiaries.\(^5\) By providing asset protection from potential creditors while still having the ability to maintain a beneficial interest in the trust, the settlor essentially has it both ways. The settlor has the benefit of treating the trust as a separate entity thereby protecting his assets from creditor claims; meanwhile, he maintains a pecuniary interest in the trust, as well as some level of control over what ultimately happens to the trust property.

The typical self-settled domestic asset protection trust (“DAPT”) may not be treated as an asset of the settlor for creditor claims. Whether these assets should be treated as owned by the settlor for the purpose of inclusion in the gross estate of the decedent for estate tax purposes is the focus of this Article. The author asserts that it is appropriate to include certain property settled in a self-settled DAPT in the settlor’s gross estate for estate tax purposes because of the control the settlor retains over the trust assets up until his death. The remainder of this Article will discuss the evolution of

\begin{footnotes}
\item[5] See Bryan Nichols, Note, “I See the Sword of Damocles Is Hanging Above Your Head!” Domestic Venue Asset Protection Trusts, Credit Due Judgments, and Conflict of Law Disputes, 22 Rev. Litig. 473, 478 (2003). “It is common knowledge that every gainful opportunity presents the potential for misfortune. If life is beset by potential misfortune, then it is worthwhile to create ways in which we can invest our energies and ward off financial threats at the same time.” Id. at 475.
\end{footnotes}
self-settled DAPTs, the estate and gift tax implications of DAPTs based on the various state statutes, and conclude with policy reasons why the property in a DAPT should be included in the gross estate of the settlor.

Alaska and Delaware, the original states to enact statutes from which other states model their domestic self-settled trust statutes, are natural choices for any in-depth analysis regarding self-settled trusts. Specific provisions from other statutes are also chosen for discussion because of some unique factors those statutes contain that distinguish them from the Alaska and Delaware Acts.

While there will be a somewhat extensive discussion on some of the commonalities that exist between self-settled DAPTs and offshore asset protection trusts ("OAPTs"), the purpose is not to attempt to justify or challenge the DAPTs or OAPTs, but rather to analyze the retained powers the settlor has retained over a portion of the trust. Furthermore, by focusing on the retained power and how the creditor protection features, the author asserts that the settlor of a DAPT still maintains a level of control that demonstrates indicia of ownership which should cause the trust assets to be treated as property of the settlor, specifically for transfer tax purposes.

I. Public Policy Regarding Self-Settled Trusts

A. Historical Treatment of Self-Settled Trusts

APTs, in general, have been available for those who can afford the costs of trust acquisition and trust administration to protect their wealth from potential creditors. In the past, the self-settled versions of these trusts were only available through offshore jurisdictions.

The primary objective of an APT is to protect assets against creditor claims. The source of asset protection is the spendthrift provision drafted

6. See generally James T. Lorenzetti, *The Offshore Trust: A Contemporary Asset Protection Scheme*, 102 COM. L.J. 138, 140 (1997) ("Although they are relatively uncommon, OAPTs are not entirely new. In 1994, it was estimated that one trillion dollars ($1,000,000,000,000) of foreign trust funds were held in OAPTs."); Elena Marty-Nelson, *Offshore Asset Protection Trusts: Having Your Cake and Eating It Too*, 47 RUTGERS L. REV. 11, 68 (1994) ("Legal fees for launching a foreign trust start at $15,000 for a $1 million account. Added to this are the administration fees of approximately one percent.").

7. See Claudia R. Tobler & Ingrid Michelsen Hillinger, *Asset Protection Devices: Twyne's Case Re-Told*, 9 J. BANKR. L. & PRAC. 3, 4, 17-18 (1999) ("Until very recently, creditors of a settlor could reach assets in a self-settled spendthrift trust in any state without proof of the settlor's intent to hinder, delay or defraud his creditors. The spendthrift clause was simply unenforceable against the settlor's creditors.").

A spendthrift is someone who spends money recklessly or is very wasteful with money. Therefore, a spendthrift provision is designed as a protective measure to limit a spendthrift’s access to assets within the trust. Spendthrift provisions, in general, are deemed legitimate based on the theory that the owner of assets may dispose of his assets in any manner he deems appropriate, including protecting the assets from a beneficiary’s creditors. It is illogical to then imagine that if the settlor himself is the spendthrift that he may place restrictions against his access to his own money, and still be able to successfully shield his assets from his creditors by reason of those restrictions. As such, according to the common law, a spendthrift clause in a self-settled trust does not provide protection of the trust assets from creditor claims. United States courts have historically permitted settlors to create spendthrift provisions within the trust for the benefit of a third party, but have not allowed such spendthrift provisions to co-exist with a self-settled trust.

The leading authorities that serve as models for most state statutes regarding property interests and transfers to trusts, the Restatement and the Uniform Trust Code, have also consistently drafted model rules forbidding a person from enjoying his property while shielding such property from his creditors. The primary policy reason for this prohibition is that a settlor have little to do with... tax consequences. The appeal of the foreign jurisdiction is, in most circumstances, the protection from potential creditors afforded by an OAPT, which is generally greater than that found in its domestic counterpart.

9. A spendthrift provision is generally a provision that prohibits the voluntary or involuntary alienation of the trust property. See RESTATEMENT (SECOND) OF TRUSTS § 152 (1959).

10. BLACK’S LAW DICTIONARY 1530 (9th ed. 2009) (defining the term as “[o]ne who spends lavishly and wastefully; a profligate”).

11. Nichols, supra note 4 (“Spendthrift trusts are deemed legitimate on the theory that the grantor reigns supreme as the owner of his assets and may therefore vest such assets in whomever he wishes and have his ownership rights insulated from the beneficiary’s creditors.”). Sjuggerud, supra note 5 (“The common law rule, followed by the vast majority of American jurisdictions, is that a self-settled trust is ineffective against the claims of creditors.”).

12. Sjuggerud, supra note 5; see also In re Jordan, 914 F.2d 197, 198-99 (9th Cir. 1990) (citing In re White, 61 B.R. 388, 392 (Bankr. W.D. Wash. 1986)). But see Ritchie W. Taylor, Domestic Asset Protection Trusts: The Estate Planning Tool of the Decade or a Charlatan?, 13 BYU J. PUB. L. 163, 168 (1998) (stating that all but two states protect trust assets from creditor claims of tort victims where the trust was a traditional spendthrift trust).

13. Nichols, supra note 4; see also In re Jordan, 914 F.2d 197, 198-99 (9th Cir. 1990) (citing In re White, 61 B.R. 388, 392 (Bankr. W.D. Wash. 1986)). But see Ritchie W. Taylor, Domestic Asset Protection Trusts: The Estate Planning Tool of the Decade or a Charlatan?, 13 BYU J. PUB. L. 163, 168 (1998) (stating that all but two states protect trust assets from creditor claims of tort victims where the trust was a traditional spendthrift trust).

14. See RESTATEMENT (THIRD) OF TRUSTS § 58 (2003) (“A restraint on the voluntary and involuntary alienation of a beneficial interest retained by the settlor of a trust is invalid.”). The Uniform Trust Code § 505(a)(2) states:
should be able to set whatever limits he chooses when making a gift to another, including spendthrift provisions.\textsuperscript{15} However, a settlor should not be able to use his assets for his own pleasure and shield those assets from beyond the reach of his creditors.\textsuperscript{16}

B. Current Spendthrift Legislation

Most states have enacted some type of spendthrift legislation.\textsuperscript{17} States without statutes addressing the spendthrift provisions of self-settled trusts still follow the common law rules regarding self-settled trusts, which do not impose the spendthrift trust laws upon trusts in which the settlor has retained an interest, at least to the extent of that retained interest.\textsuperscript{18} Therefore, historically, where settlors created a

\begin{quote}
Whether or not the terms of a trust contain a spendthrift provision . . . [w]ith respect to an irrevocable trust, a creditor or assignee of the settlor may reach the maximum amount that can be distributed to or for the settlor's benefit. If a trust has more than one settlor, the amount the creditor or assignee of a particular settlor may reach may not exceed the settlor's interest in the portion of the trust attributable to that settlor's contribution.
\end{quote}

In the comments that follow, the drafters state “Subsection (a)(2), which is based on Restatement (Third) of Trusts Section 58(2) and cmt. e (Tentative Draft No. 2, approved 1999), and Restatement (Second) of Trusts Section 156 (1959), follows traditional doctrine in providing that a settlor who is also a beneficiary may not use the trust as a shield against the settlor's creditors.” UNIF. TRUST CODE § 505(a)(2) (2005). A spendthrift provision is ineffective against a beneficial interest retained by the settlor. See RESTATEMENT (THIRD) OF TRUSTS § 58 cmt. e (Tentative Draft No. 2, approved 1999). This is a necessary corollary to section 505(a)(2), which allows a creditor or assignee of the settlor to reach the maximum amount that can be distributed to or for the settlor's benefit. This right to reach the trust applies whether or not the trust contains a spendthrift provision. UNIF. TRUST CODE § 505(a)(2) (2005).

15. See Karen E. Boxx, Gray's Ghost—A Conversation About the Onshore Trust, 85 IOWA L. REV. 1195, 1199 (2000) (“Generally, while U.S. courts will allow a [settlor] to establish a spendthrift trust for the benefit of a third party, . . . a [settlor] cannot set up such a trust for his or her own benefit.”).

16. See id. (“[A] trustor should be able to set whatever limits she chooses when making a gift to another, including spendthrift provisions, but should not be able to place her assets beyond her own creditor's reach, while still retaining use of those assets.”).

17. See Marty-Nelson, supra note 6, at 29 (“Half [of the states] have enacted some type of spendthrift legislation.”); David M. Repp, Asset Protection (For the Rich and Not) in Iowa, 56 DRAKE L. REV. 105, 113 (2007) (“Since the Supreme Court’s decision [to recognize spendthrift trusts] in 1875, every state has adopted or enacted some form of a spendthrift trust provision . . . .”).

18. See Repp, supra note 17 (“The United States Supreme Court broke from English common law in 1875 by authorizing the use of spendthrift trusts.”).
self-settled trust, the assets therein were treated as continuously owned by the settlor for the purpose of satisfying creditor claims. A trust was typically deemed to be a self-settled trust if the settlor was a beneficiary of the trust, retained dominion and control, and/or retained a right to financial support from the trust.

II. Tax Treatment of Self-Settled DAPTs

A. Potential Impact by Government Branches

There are three primary entities that possess the potential to have the greatest impact on the tax treatment of a transfer from a DAPT at the settlor's death. The first entity is the legislative branch. There is no specific code section that directly addresses Congress's tax treatment of domestic asset protection self-settled trusts. While different states across the country continue to create their versions of these APTs, Congress has yet to directly engage in a discussion regarding the specific tax treatment of transfers from these specific types of trusts. Certainly enough time has passed for Congress to address these newly enacted state legislative acts on a federal level, hence the inaction may be due to Congress' belief that there is no reason to act because §§ 2036 and 2038 adequately address the matter with the retained interest provisions. It is also likely that Congress has not addressed the matter because their constituents may not want the matter addressed, or members of Congress simply do not believe the issue is important enough to address at the moment. While the author asserts that §§ 2036 and 2038 cause inclusion of DAPT assets in the gross estate of the settlor, Congress should directly confront the tax treatment of transfers to and from DAPTs through specific legislation designed for trusts where creditor access is restricted while the settlor still retains certain powers.

The next entity is the judicial branch. The actions taken by this branch are largely dictated by the action or inaction of the other government branches. At different levels of the judiciary branch, courts, varying by jurisdiction, will likely treat transfers from certain self-settled trusts differently. Those few states with statutes providing for DAPTs will be


20. See Taylor, supra note 13. Courts have traditionally considered a trust self-settled if one of several factors are present from the settlor: the settlor is a beneficiary, retains dominion and control over the trust corpus, retains and reserves a general power of appointment in himself, or creates the trust for his was created for the settlor's own purpose.

directly at odds with the majority of states that still do not permit self-settled DAPTs. Take for example a settlor who lives and has possession of real property located in Florida, but holds this property in a DAPT settled in Alaska. Whether the court permits creditor access in one jurisdiction versus the other is important because creditor access is a factor in determining whether the property should be includable in the gross estate of the decedent after his death.\(^22\)

The final participant is the executive branch. Specifically the Internal Revenue Service ("IRS") has thus far issued private letter rulings ("PLRs") on very narrow issues regarding income and gift taxation which may give a hint, but no clear indication, of how the IRS will treat DAPTs for estate tax purposes. Since PLRs are not binding, except for the individual seeking the PLR, we cannot rely on a ruling provided in a PLR, even if the individual disclosed all pertinent information for purposes of the PLR. In short, there is no real way to predict how the IRS will treat the settlor’s interest in a self-settled DAPT for estate tax purposes as the discussion in this Article will reflect.

### B. The Advent of DAPTs

Since 1997, a number of states have created some version of a self-settled spendthrift trust with varying criteria.\(^23\) Some of the common features of these trusts are irrevocability or restrictions on revocation, spendthrift provisions, and permissible distributions to the settlor of the income interest while limiting exposure to creditor claims.\(^24\) High net worth individuals gravitate towards these trusts to protect and preserve a portion of their riches.\(^25\)

These domestic self-settled APTs are noted for their asset protection features, which in some cases have been tested and upheld.\(^26\) Because of the focus on the possibility of being sued and the speculation of the impending death of the estate tax, APTs in general have became

\(^{22}\) For the detailed discussion of the creditor access to assets and how it impacts whether a completed transfer has occurred, see infra text accompanying note 97.

\(^{23}\) Shaftel, supra note 3 (comparing the twelve domestic asset protection statutes).

\(^{24}\) Nichols, supra note 4, at 476.

\(^{25}\) See Taylor, supra note 13 (citing Herzog v. Comm’r, 116 F.2d 591, 594 (2d Cir. 1941) (holding that the discretionary trust was a valid spendthrift trust because the settlor was not the only income beneficiary of the trust)).
increasingly popular over the last decade while tax planning may have received less attention. Now that it appears that speculation surrounding the demise of the estate tax was premature, a question lingers as to whether the settlor has relinquished enough control to deem the transfer a completed gift to the self-settled DAPT. In reviewing the taxability of any property transferred to a self-settled DAPT, the debate is whether the transfer should be appropriately taxed during the lifetime of the settlor as a gift, or whether the transfer should be appropriately taxed at the death of the settlor through his estate.

III. The Influence of the Self-Settled APT

The Alaska DAPT made its debut in 1997. Since that time, a number of states have enacted statutes permitting self-settled trusts in the United States. This section of the Article will address the evolution of these trusts and how the offshore version played a major role in their migration to the United States.

A. The Evolution of Asset Protection Instruments

A number of different categories of asset protection instruments have been available for decades. Some of the traditional methods of asset protection include the use of limited liability corporations (“L.L.C.”), limited liability partnerships (“L.L.P.”), and family limited partnerships (“F.L.P.”). The use of L.L.C.s, L.L.P.s, and F.L.P.s as asset protection instruments originated for legitimate businesses purposes, with the added benefit of protection from personal liability from the creditors of the business. As such, these asset protection instruments have the distinction of serving a legitimate purpose; accordingly, they have been honored, and continue to be honored. For that reason, L.L.C.s, L.L.P.s, and F.L.P.s are available as legitimate asset protection instruments if the entity is properly established and administered.

27. See id. at 164 (“Currently, asset protection trusts are the most popular method of using offshore financial centers to achieve asset protection. It is estimated that over $1 trillion of foreign trust funds are in asset protection trusts.”).
29. Shaftel, supra note 3, at 293.
30. See Nichols, supra note 4, at 476.
31. Id.
32. Id.
33. Tobler & Hillinger, supra note 7, at 5-6. With partnerships in general, there is a general partner who is fully liable for debts of the partnership and the limited partners are
B. Self-Settled OAPTs

Because of the litigious nature of the United States society, many professionals seek refuge for their accumulated wealth as they fear the possibility of a lawsuit. Professionals such as doctors, lawyers, and business owners are more susceptible to lawsuits—primarily malpractice suits. Therefore, it is not surprising that they sought protections for their personal assets by establishing offshore trusts. By 1994 it was estimated that over $1 trillion were invested in OAPTs. The primary purpose of the typical offshore trust is to shield assets from potential future creditors.

Self-settled OAPTs are another category of asset protection instruments that have been available for decades. OAPTs have been favored over L.L.C.s, L.L.P.s, and F.L.P.s for the added layers of protection they provide against virtually all creditors, not just those creditors associated with the business. This is because the court is forced to deal with the settlor who may be willing to suffer contempt charges in exchange for keeping his assets within the trust. If an international treaty liable to the extent of their interest in the partnership. Opponents of the F.L.P.s argue the use of F.L.P.s is an abuse of partnership law by families to shift income tax liability from high-income tax bracket family members to the lower-income tax bracket family members.

34. Roder, supra note 19, at 1254.
35. Id.
36. Id.
37. Id.
38. Marty-Nelson, supra note 6, at 12. Offshore asset protection trusts ("OAPTs") are trusts established under foreign laws by United States Citizens designed to lawfully remove assets from a settlor's balance sheet without creating adverse federal transfer tax consequences or losing all control over assets. Id. at 12-13.
40. See In Re Lawrence 227 B.R. 907 (Bankr. S.D. Fla. 1998). Following the stock market crash in 1987, Stephan Lawrence experienced a margin deficit with Bear, Stearns and disagreed about the extent of the margin. Just before an arbitrator granted an award in favor of Bear, Stearns for an amount in excess of $20,000,000 Lawrence settled an offshore asset protection trust with approximately $7,000,000 in the Jersey Channel Islands and amended the same trust to change the situs. The trust was amended again to add spendthrift and anti-duress provisions after Lawrence was aware of the impending order. As Sterns attempted to collect his judgment, Stern claimed impossibility as a defense to repatriating the assets. The court held Lawrence in contempt and sentenced him to jail. See also In re Lawrence, No. 05-20485, 2007 WL 5080506 (S.D. Fla. Nov. 19, 2007) where the court released Lawrence after he served six years of incarceration. The court believed that more time would not compel Lawrence to comply with the contempt order.
or agreement does not exist between the offshore jurisdiction and the United States, it becomes extraordinarily difficult to force repatriation of the assets.\textsuperscript{41}

For instance, judgments that may be obtained by creditors in the American court system will be unenforceable in foreign jurisdictions that do not have a treaty or agreement with the United States.\textsuperscript{42} Another reason that a foreign jurisdiction contributes to the difficulty in reaching the trust assets is the "debtor friendly" legal system which is often present in the offshore jurisdictions that market self-settled APTs.\textsuperscript{43} These features tend to make the offshore trust more attractive to those seeking ways to protect their assets than the domestic L.L.C.s, L.L.P.s, and F.L.P.s.

In order to maximize the efforts of shielding the assets, an offshore trust is the logical choice because it is more difficult for a creditor to enforce a court order in a foreign jurisdiction than in a domestic jurisdiction.\textsuperscript{44} Additionally, the public receives legal information regarding APTs from practitioners specializing in the field who clearly have a vested interest in promoting these trusts as a great resource.\textsuperscript{45}

On the other hand, having an offshore trust does not solve all of the problems related to protecting assets. Certainly the OAPTs tend to frustrate the purpose of the American trust laws against self-settled trusts; however, OAPTs are not risk free.\textsuperscript{46} Because of the nature of the offshore trust business, a foreign trustee, who is normally not known personally by the settlor, is ordinarily employed to administer a trust.\textsuperscript{47} Therefore, it may become difficult for the settlor to truly give up all control over the property. An example of such can be found in a case from the Ninth Circuit, \textit{FTC v. Affordable Media, L.L.C.} where the court held the Andersons (defendants) had a self-settled OAPT of which they were co-trustees with a foreign

\begin{footnotesize}
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\item \textsuperscript{41} Roder, \textit{supra} note 19, at 1256.
\item \textsuperscript{42} See \textit{id}.
\item \textsuperscript{43} \textit{id.} at 1257.
\item \textsuperscript{44} \textit{id.} at 1256-57. As a sovereign nation, a foreign jurisdiction is not required to comply with a court order issued by a United States court because those court orders are not recognized in the Offshore Asset Protection jurisdictions. \textit{id.} at 1256.
\item \textsuperscript{45} Marty-Nelson, \textit{supra} note 6, at 14-15 ("Virtually all of the . . . literature on offshore asset protection trusts has been contributed by practitioners specializing in the field. As such, the literature paints a fairly rosy picture of OAPTs. OAPT specialists tout them as a panacea against virtually all creditor risks.").
\item \textsuperscript{46} \textit{id.} at 66-71. As previously mentioned, one of the foundational principles of American trust law is that a settlor should not be able to transfer his assets to a trust, enjoy the benefits of the trust, and still shield those assets from his creditors. Additionally, when investing money in a foreign jurisdiction, settlors could face problems due to the political climate of the foreign jurisdictions. \textit{id.} at 66.
\item \textsuperscript{47} See \textit{id.} at 67.
\end{itemize}
\end{footnotesize}
trustee. When the Andersons failed to repatriate funds from their OAPT to satisfy the judgment against them, the court held them in contempt.

In this case, the defendants were involved in a Ponzi scheme that caused investors to lose all of their money while the defendants transferred the commissions they earned in the Ponzi scheme to an OAPT in the Cook Islands. The district court entered a preliminary injunction against the defendants and required the defendants to obtain an accounting of and to repatriate their foreign assets. The defendants then submitted a request for an accounting and a copy of the court order to the foreign trustee and further requested repatriation of the trust assets to be deposited with the court. When the foreign trustee received the request, it invoked the “event of duress” clause, automatically removing the defendants as co-trustees of the trust, and refused to comply with the court order. The defendants then asserted that it was impossible to comply with the court order because the foreign trustee had refused to repatriate the funds based on the prohibitive language in the trust and the court held them in contempt.

In asserting the defense of impossibility, the defendants relied on the Supreme Court ruling in United States v. Rylander, which held, in part, that a valid defense to a contempt charge is the inability to comply with a court order due to a lack of possession or control of the evidence or document in question. For that reason, the Andersons probably believed they had prepared for all contingencies that might arise and require them to repatriate the funds. While the court had no jurisdiction to repatriate the

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48. FTC v. Affordable Media, L.L.C., 179 F.3d 1228, 1241 (9th Cir. 1999) (compelling the defendants to take action because they were subject to the personal jurisdiction of the court).

49. Id.

50. See id. at 1231-32.

51. See id. at 1232.

52. See id. The trust was structured such that, while the defendants were the original co-trustees, they were to be automatically removed under the “event of duress” clause. See id. at 1239 n.9 (“Under the trust agreement, an event of duress includes the issuance of any order, decree or judgment of any court or tribunal in any part of the world which in the opinion of the protector will or may directly or indirectly, expropriate, sequester, levy, lien or in any way control, restrict or prevent the free disposal by a trustee of any monies, investments or property which may from time to time be included in or form part of this trust and any distributions therefrom.”) (internal quotation omitted).

53. See id. at 1232.

54. See FTC, 179 F.3d at 1239.

trust assets, the Ninth Circuit looked to the level of control the Andersons retained over the trust and upheld the contempt order.\textsuperscript{56}

By naming themselves as trust protectors, the Andersons had the ability to control distributions.\textsuperscript{57} Naming themselves as trust protectors was a factor the court used to determine that the Andersons retained enough control to repatriate the funds if they desired to do so.\textsuperscript{58} If the Andersons had known the trustee personally or had better access to the trustee, perhaps they would have been more willing to give up the necessary control over the trust assets in order to render the trust assets totally out of their control. The Andersons probably feared that they would have little recourse if the foreign trustee depleted the trust assets and disappeared, because they would have been required to pursue an action against the trustee in the Cook Islands, hire a foreign attorney, etc., and potentially lose the claim in addition to their trust assets. In addition, with millions of dollars at stake, maintaining some level of control was probably a significant factor in the Andersons' decision to appoint themselves as trust protectors over the trust; this likely provided them with some assurance that they would still have a fortune when their creditor worries were over.

Nonetheless, OAPTs typically have features similar to those described in the Anderson trust. Though not all of these features were present in the Anderson trust, nor are they present in all OAPTs such features are as follows: irrevocability, settled in a foreign jurisdiction with a foreign trustee, restriction on the ability to repatriate the trust funds, reversionary interest in the settlor, and the settlor maintaining some measure of control

\textsuperscript{56} See FTC, 179 F.3d at 1242 ("The district court's finding that the Andersons were in control of their trust is well supported by the record given that the Andersons were the protectors of their trust. A protector has significant powers to control an offshore trust.") (citing Gideon Rothschild, Establishing and Drafting Offshore Asset Protection Trusts, 23 EST. PLAN. 65, 70 (1996) ("The use of a trust protector or advisor is common among foreign trusts. This person . . . has the power to replace trustees and veto certain actions by the trustees.")).

\textsuperscript{57} Restatement (Third) of Trusts § 64 (2003). A trust protector is an advisor to the trustee of a trust. The trust protector is generally given the power to terminate the trust, veto distributions, modify or clarify terms for the purpose of achieving tax or non tax objectives, improving administration to facilitate the settlor's objectives, or adding or altering a beneficiary's rights.

\textsuperscript{58} Id. at 1241-43. The district court judge stated,

[a]s I look at the totality of the scheme of what I see before me at this time, I have no doubt that the Andersons can if they wish to correct this problem and provide the means of putting these funds in a position that they can be accountable if the final determination of the Court is that the funds should be returned to those who made these payments.

\textit{Id.} at 1242.
over the trust as a member of a committee of advisors or as a trust protector. These features certainly make the foreign trust very attractive as an asset protection vehicle. In addition, foreign countries that offer OAPTs tend to be debtor friendly; therefore, making it more difficult and expensive for a creditor to pursue an action against the debtor. Until 1997, no domestic jurisdiction offered a level of security for trust assets comparable to the OAPT.

In order to provide ease in navigating the relevant asset protection statutes and various provisions incorporated therein, we will follow James Smith, a fictitious client who seeks advice from an associate at the law firm of Estate Planners Authority. James Smith is a wealthy businessman who has various assets with an estimated value of five million dollars. He is not married, but he has two children from a prior marriage, he lives in Florida, and has heard about APTs and seeks advice as to whether he should transfer his property to such a trust.

James Smith was referred to Estate Planners Authority because the firm has experts licensed to practice in a variety of jurisdictions including Alaska, Delaware, and Nevada. James is specifically interested in finding out more information regarding the trust laws in these states. He is worried about the possibility of being sued, but he does not have any pending court actions against him or creditors seeking payment. He expressed an additional goal of avoiding estate taxes in order to pass as much property as possible to his family upon his death. Though he is a multi-millionaire, he does need to maintain control over some of the income that will used to fund the trust in order to maintain his high standard of living since the vast majority of his wealth is comprised of investments in income producing property.

IV. Alaska Trust Act ("ATA")

A. Introduction

The ATA was first enacted in 1997 and was subsequently amended and expanded in 1998, 2003, 2004, 2006, and 2008. The current

60. Roder, supra note 19, at 1255-57.
62. Id.
version of the statute provides, in pertinent part, that a person who transfers property in trust with a written instrument "may provide that the interest of a beneficiary of the trust, including a beneficiary who is the settlor of the trust," not voluntarily or involuntarily alienate the property before the delivery of such property to the beneficiary by the trustee.  

The statute further states, in pertinent part, that if a trust has the aforementioned spendthrift provisions, an existing creditor or subsequent creditor is prevented from satisfying a claim against a beneficiary of the trust unless the settlor is the beneficiary and the creditor was a creditor of the settlor at the time the trust was created. These exceptions to the restrictions on creditors of the settlor provide creditors with a very narrow opportunity to gain access to the trust.

These exceptions are debtor friendly, as are their offshore counterparts, in that unless the creditor can prove that James, as the settlor of the trust: (1) made a fraudulent transfer; (2) retained the power to revoke or terminate the trust without the consent of a person having a substantial adverse interest; or, (3) included a provision that the trust's income or principal must be distributed to him, then the assets are protected from the creditor's claims.

68. ALASKA STAT. § 34.40.110(a) (2008).

69. Id. § 34.40.110(b) (emphasis added). "If a trust contains a transfer restriction allowed under (a) of this section, the transfer restriction prevents a creditor existing when the trust is created or a person who subsequently becomes a creditor from satisfying a claim out of the beneficiary’s interest in the trust . . . .” Id.

70. See id. Section (b) of the statute specifically states:

[U]nless the creditor is a creditor of the settlor and

(1) the settlor's transfer of property in trust was made with the intent to defraud that creditor, and a cause of action or claim for relief with
Armed with this information, James Smith asks the firm to establish a trust to which he may transfer his assets, shield those assets from creditors, and facilitate his ability to receive some, but not all, trust income. He emphasizes that the transfer should minimize estate taxes as well as ensure respect to the fraudulent transfer complies with the requirements of (d) of this section;

(2) the trust . . . provides that the settlor may revoke or terminate all or part of the trust without the consent of a person who has a substantial beneficial interest in the trust and the interest would be adversely affected by the exercise of the power held by the settlor to revoke or terminate all or part of the trust; in this paragraph, “revoke or terminate” does not include a power to veto a distribution from the trust, a testamentary nongeneral [special] power of appointment or similar power, or the right to receive a distribution of income, principal, or both in the discretion of a person, including a trustee, other than the settlor, or a right to receive a distribution of income or principal under (3)(A), [or] (B) . . . of this subsection;

(3) the trust . . . requires that all or a part of the trust’s income or principal, or both, must be distributed to the settlor; however, this paragraph does not apply to a settlor's right to receive the following types of distributions, which remain subject to the restriction provided by (a) of this section until the distributions occur:

(A) income or principal from a charitable remainder annuity trust or charitable remainder unitrust; in this subparagraph, “charitable remainder annuity trust” and “charitable remainder unitrust” have the meanings given in 26 U.S.C. 664 (Internal Revenue Code) as that section reads on October 8, 2003, and as it may be amended;

(B) a percentage of the value of the trust each year as determined from time to time under the trust instrument, but not exceeding the amount that may be defined as income under AS 13.38 or under 26 U.S.C. 643(b) (Internal Revenue Code) as that subsection reads on October 8, 2003, and as it may be amended;

(C) the transferor's potential or actual use of real property held under a qualified personal residence trust within the meaning of 26 U.S.C. 2702(c) (Internal Revenue Code) as that subsection reads on September 15, 2004, or as it may be amended in the future; or

(D) income or principal from a grantor retained annuity trust or grantor retained unitrust that is allowed under 26 U.S.C. 2702 (Internal Revenue Code) as that section reads on September 15, 2004, or as it may be amended in the future; or

(4) 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.

Id.
protection of his assets from creditors. James understands that this will not be an inexpensive endeavor; however, he is certain that, in consideration of the totality of the circumstances, he will be able to better protect his assets from creditor claims, and that he may reduce his tax liability as well if his goals are accomplished.

Further, James also wants to know what would happen should a situation develop where he might be sued, for instance, if he were involved in a car accident where he was wholly at fault. Assuming that the applicable exclusion rate\(^\text{71}\) is $3.5 million for estate tax and the gift tax remains at $1 million, James wants to know what the possible consequences are during his lifetime and after death. In navigating the statute and applying the terms to James's desired goals, the first step is to establish whether the gift tax is applicable at the time of the proposed transfer, or whether it is more appropriate to impose the tax at his death.

B. Gift Tax Implications

1. Introduction

Internal Revenue Code ("IRC" or "the Code") § 2501 imposes a tax on a transfer of property by gift.\(^\text{72}\) Taxable gifts are defined as "the total amount of gifts made during the calendar year, less [permissible] deductions."\(^\text{73}\) Transfers include transfers to a trust by direct or indirect gift.\(^\text{74}\) Based on these definitions, it appears that as long as our client, James Smith, does not retain discretionary control over the trust property, it should be fairly simple to draft an instrument in such a way as to make the transfer a completed gift. For the purpose of this illustration, we will presume this trust instrument includes the maximum powers the Alaska statutes permit in order to discuss those specific problematic powers. To make the transfer qualify as a completed gift for federal transfer tax purposes, James must relinquish dominion and control over the property in trust therefore one of the challenges is to determine whether such control still remains with the settlor.

The Alaska statute permits James to name himself as a permissible beneficiary and include a spendthrift clause restricting his voluntary and

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71. The applicable exclusion rate is the dollar amount determined by Congress to permit a decedent's estate to pass free of estate taxes. BLACK'S LAW DICTIONARY 115 (9th ed. 2009).
72. I.R.C. § 2501 (2006) (providing, in pertinent part, a tax "imposed for each calendar year on the transfer of property by gift during such calendar year by an individual resident").
73. Id. § 2503(a).
74. Id. § 2511(a).
involuntary alienation of the trust assets.  An independent trustee will likely be named and be given absolute discretion regarding payments of income and principal to the settlor/beneficiary, i.e., James, in accordance with the statute. The trust instrument will likely have language stating that there are no express or implied agreements between James, as the settlor, and the trustee regarding payments to James, as the beneficiary. Of particular interest is the fact that the Alaska statute permits the settlor to possess a testamentary nongeneral power of appointment over the trust property, and still permits the trust property to qualify for the protections of the statute.

2. Possession of a Power of Appointment

Possession of a testamentary nongeneral power of appointment in a trust has some significant benefits to the power holder. For instance, the power holder is permitted to decide the ultimate beneficiary amongst a group of predetermined beneficiaries of the trust assets without any further restrictions. Therefore, the power holder may alter the beneficial interest of a beneficiary or terminate the interest of a beneficiary altogether without that nongeneral power being treated as substantial enough interest to treat the property subject to the power as that of the power holder. In our example, once James establishes and funds his trust, he may maintain a testamentary nongeneral power of appointment over the trust; possession of that power alone does not cause the trust to be treated as his asset for purposes of satisfying a car accident victim’s claim. While a settlor may not maintain a general power of appointment in a self-settled DAPT one example of how a power of appointment may be used to achieve optimum tax goals is best illustrated in the case of a general power of appointment retained by a settlor, in a grantor trust. As a grantor trust, the trust will not

75. ALASKA STAT. § 34.40.110(a) (2008).
76. I.R.C. § 674(c) (providing an independent trustee is defined as “a trustee or trustees, none of whom is the grantor, and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor”).
77. This is anticipated since if there are express or implied agreements, the trust would not qualify for certain favorable tax treatment as well as favorable creditor treatment.
78. A general power of appointment is defined as “a power which is exercisable in favor of the individual possessing the power . . . , his estate, his creditors, or creditors of his estate.” I.R.C. § 2041(b). Powers of appointment that not considered general are nongeneral.
80. I.R.C. § 2041(b).
81. Section 674 of the IRC states, “[t]he grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income
be treated as a separate entity from the grantor, and the grantor will continue to be taxed on the income generated by the trust.\(^\text{82}\) Because the income tax code and regulations are separate and apart from the estate and gift tax code and regulations, the grantor trust rules are one example of the dissension between the two taxing systems.\(^\text{83}\) Ordinarily, it would not seem beneficial to pay a tax on property that a person has decided to part with. However, estate planners routinely recommend that a settlor intentionally treat a trust as a grantor trust because the settlor is then permitted to use his other assets to pay the income tax obligation of the trust.\(^\text{84}\)

This technique is effective because by using other assets owned by the grantor to pay the income tax obligation, the grantor essentially makes two gifts.\(^\text{85}\) The first gift is the payment of the income tax obligations of the trust. This allows for the second "gift," which is the trust's continual increase in value for the ultimate beneficiaries without increasing the gift tax obligation for the additional value.\(^\text{86}\) Despite the fact that the trust is deemed a grantor trust because of the retained control for income tax purposes, this retained control is not enough to automatically eliminate the

\[\text{82. Section 671 of the IRC states:}\]

\[\text{Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual.}\]

\[\text{Id.} \ § 671. \ See \ also \ Marty-Nelson, \ Taxing \ Offshore \ Asset \ Protection \ Trusts, \ supra \ note \ 8, \ at \ 419.\]

\[\text{83. See Marty-Nelson, Taxing Offshore Asset Protection Trusts, supra note 8, at 416.}\]

\[\text{84. See id.}\]

\[\text{85. See id. at 417.}\]

\[\text{86. Id. at 416-17 ("When properly configured, intentional grantor trusts boost the economic value of a donor's transfer of assets to donees dramatically. The trust is structured such that the grantor of an intentional grantor trust is responsible for paying income taxes on trust income even though the underlying assets generating that income have already been transferred to the donee. Accordingly, since the donor is paying his own tax obligation, that tax payment is not deemed an additional gift subject to gift taxes. Careful planning is often required, since the benefits of intentional grantor trusts can rise or fall depending on the family unit's particular tax picture. The essential benefit of an intentional grantor trust, however, is that additional 'gifts' (in the form of income tax payment) are not subject to any additional gift tax.")}. \]

\[\text{The second "gift" of appreciation is not really a gift as defined for transfer tax purposes, but is an additional benefit by the recipient.}\]
transfer’s status as a completed gift. Therefore, an exploration of both the estate and gift taxing statutes and regulations are in order.

Generally, whether James’s DAPT is afforded the protections of the Alaska statute, and whether his creditors would have the ability to access the trust to satisfy creditor claims, is not important for this discussion. However, the reason for the substantial discussion here is because conventional wisdom dictates that when the settlor’s property is beyond the reach of his creditors, the transfer is treated as a completed gift, and is therefore taxable at the time of transfer. The effective rate of taxation imposed for a transfer by gift is lower than the effective rate imposed on a transfer through the estate, this is an important consideration as to whether a settlor would prefer to have the transfer treated as a complete transfer made during life as opposed to having the transfer occur at his death. The effective rate refers to the fact that the gift tax is “tax exclusive,” and therefore the applicable tax is payable on the actual amount of the gift transferred, and the transferor will use other assets to pay the tax owed. On the other hand, the estate tax is “tax inclusive” in that the assets used to pay the tax are included in the calculation to determine the applicable tax, so fewer assets are ultimately transferred. So while the gift tax is imposed earlier in time, the overall wealth transferred from the settlor to his beneficiaries is potentially much higher.

87. Id.
88. See Taylor, supra note 13.
89. See Marty-Nelson, Taxing Offshore Asset Protection Trusts, supra note 8, at 416-17.
90. See id. at 420-21.
91. See id.
92. See id. at 417. This Article provides a comparison of two examples to demonstrate the impact of the grantor trust status. The examples are as follows:

[1.] Outright gift. In year [one], a parent transfers $1,000,000 outright to her adult son. With a ten percent return, by year [two], the gift generates income of $100,000. Both parent and son are in the highest individual tax bracket of 39.6%. Given these figures, the federal tax liability on the $100,000 would be about $40,000. If the parent is intent on the son benefiting not just from the initial gift but also from all the income generated by that gift, the parent can agree to pay the income tax liability attributable to the gift. In that case, the parent pays the $40,000 income tax liability and the son benefits from the full $1,100,000 by year [two]. The parent’s payment of the son’s income tax liability would, however, be deemed a gift from the donor/parent subject to gift tax liability. In the event the parent has used all of her unified credit and already makes annual exclusion gifts to the son, the $40,000 tax payment to the Service, [sic] would be subject to gift tax liability. If the [fifty-five percent] gift tax rate applied, $22,000 would be due on the parent’s payment of the son’s liability.
In general, the IRS looks to state law to determine legal interests and rights and the scope by which a creditor may gain access to the property of a debtor. The Supreme Court has established that the role of the states is to determine property rights and interests, while the federal government determines which interests should be taxed. With respect to creditor access and the extent to which such access determines how the subject property is treated for gift tax purposes, state law determinations should ordinarily receive deference. With DAPT laws, however, there may be a conflict of interest between a state’s obligation to determine property rights and the state’s pecuniary interest in such property. Therefore, despite the label the state may attach to a certain property interests, the property should still be treated as owned by the settlor for transfer tax purposes.

For instance, Alaska is able to generate revenue through trust administration fees. Alaska trust statutes require some or all of the property to be physically located in the State of Alaska. The statutes also reserve exclusive jurisdiction over Alaska trusts in the courts. The state laws of Alaska govern validity, construction, and administration of Alaska trusts.

[2.] Intentional Grantor Trust. Assume the same facts as in the previous case, except that instead of an outright gift, the parent transfers the initial $1,000,000 to an intentional grantor trust and names the son as the beneficiary. In this case, the parent would be liable for the income taxes under the grantor trust rules. As in the first example, the parent would pay the $40,000 in income tax. By year [two], the son becomes the beneficiary of the trust assets worth $1,100,000. Unlike example one, however, the payment of the $40,000 income tax would not be considered a gift subject to gift tax liability, because the parent would be paying her own obligation.

Id. at 417-18.

93. Id. at 427.


95. Amy Lynn Wagonfeld, Note, Law For Sale: Alaska and Delaware Compete for the Asset Protection Trust Market and the Wealth that Follows, 32 VAND. J. TRANSNAT’L L. 831, 834-35 (1999) (“It seems that the Alaska and Delaware legislators may be willing to ignore what is fair to creditors in order to bring money into their states. In fact, these legislators may be putting the interests of their respective states, as well as the interests of wealthy asset protectors, before the rights of creditors, previously held concepts of fairness, and what has been the prevailing law in this country. If estate planners and asset protectors elect to utilize trusts under these new statutes, Alaska and Delaware stand to be the depositories of massive amounts of wealth. This will translate into financial growth in each state through increased business among banks, attorneys, accountants, financial advisors, and any other professions that will assist clients in establishing and managing these trusts, the benefits of which will trickle down throughout each state’s economy.”).

96. ALASKA STAT. § 13.36.035(a), (c) (2008).
These restrictions will make the trusts easier to manage from a trustee’s perspective because the trustee will have to deal only with the laws of Alaska when determining his duties and obligations as trustee; these are the rational bases for incorporating such requirements into the Alaska trust statutes. Requiring the property to be physically located in Alaska protects the debtor because the risk that another jurisdiction will not honor the trust, or otherwise place restrictions on the debtor with property physically located in that other jurisdiction, is virtually eliminated. These rational bases, however, do not override the clear pecuniary interest the state has in keeping the trust administration funds coming to and remaining in the State of Alaska.97

The ATA makes specific, restrictive provisions for creditors to challenge DAPTs in order to gain access to the trust property therein.98 In section 13.36.310, the statute states unless there is a violation under section 34.40.110,99 a trust otherwise falling under laws of Alaska

is not void, voidable, liable to be set aside, defective in any fashion, or questionable as to the [donor’s] capacity, . . . on the grounds that the trust . . . defeats a right, claim, or interest conferred by law on a person by reason of a personal or business relationship with the [donor] . . . or by way of a marital or similar right.100

When cross-referenced with section 34.40.110(b),101 this provision states that the transfer to the trust is valid unless: (1) the conveyance was made with the intent to hinder, delay, or defraud creditors or other persons; (2) the donor had the power to revoke or terminate the trust without the consent of persons with substantial interests; (3) all the income or principal will be paid to donor; or, (4) the donor is in default by thirty or more days for child support payments pursuant to a court order.102

In order to challenge the validity of the trust, creditors must circumvent a very high burden. This is important because one of the key considerations in determining when a transfer is complete for gift tax purposes is whether state law allows creditors to pierce the trust to satisfy

97. Jeremy M. Veit, Note, Self-Settled Spendthrift Trusts and the Alaska Trust Act: Has Alaska Moved Offshore?, 16 ALASKA L. REV. 269, 269 (1999). One of the primary motivations to establish the ATA was to stimulate economic development in Alaska by attracting millions of dollars in trust investments by providing asset protection trusts ("APTs") which had only been available offshore.

99. Id. § 34.40.110.
100. Id. § 13.36.310.
101. Id. § 34.40.110(b).
102. Id. §§ 13.36.310, 34.40.110(b).
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claims. If assets are subject to claims of the settlor's creditors, then the transfer of property to an irrevocable inter vivos trust may be challenged as to whether a completed gift has occurred, even if it is a discretionary trust at least to the extent the assets are subject to the settlor's creditors. Therefore, creating the trust to protect against creditor claims may have a direct impact on whether the transfer is treated as a completed gift for transfer tax purposes.

The potential for a windfall for the settlor's beneficiaries is enormous and inequitable. For instance, the settlor may make a transfer by gift when the settlor believes the property has high appreciation potential. Once the transfer is made by completed gift, any appreciation that occurs afterward will neither be subject to estate taxation from the settlor's estate at his death, nor additional gift taxation for the added value. As long as the settlor ensures that the lifetime transfer is a completed gift, he may be able to avoid the estate transfer tax at his death. The settlor may do so by declining to retain any of the prohibited powers. Such maneuvering along the lines of estate and gift taxation should not be permitted where the settlor has released property from one hand, while retaining it with the other.

By retaining a testamentary nongeneral power of appointment over trust property in a self-settled trust, the settlor essentially gives away the property without really giving up all rights regarding the property. Possession of a testamentary nongeneral power, though limited, is still a reservation of power whereby the settlor has retained the right to decide who will ultimately own or possess the property, but the settlor may not choose to appoint the property to his estate or creditors with this limited power. Despite the fact that a creditor will not be able to reach the transfer for satisfaction of claims, that retention of a nongeneral power of appointment should still disqualify this transfer as a completed gift.

The settlor's possession of a nongeneral power of appointment signifies a retained right to decide what will happen to the property, which

104. See id. "The transfer of property to an irrevocable inter vivos trust created in, and administered under the laws of, a state in which the trust is deemed a 'discretionary trust' whose assets are subject to claims of the grantor's creditors, does not constitute a completed gift." Id.
105. See id. "If and when the grantor's dominion and control of the trust assets 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 for Federal gift tax purposes . . . ." Id.
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is an important property right. Although the provisions of the Alaska statutes protect the property from creditors, the same protections are not extended to retained powers under the Code. Under the provisions of the Code, the possession of a general power alone is enough to create an interest in the property that is subject to taxation in the gross estate for estate tax purposes. The Code does not have a similar provision stating that the possession of special power would cause inclusion in the gross estate for estate tax purposes.

Because the possession of a general power is a property interest, the provisions of the Code state that the exercise or release of a general power of appointment shall be treated as a transfer by the person who holds the power—in this case, the settlor. The exercise of a general power requires the settlor to affirmatively act by exercising the power and appointing the property to a third party beneficiary. A release of a general power occurs when the holder of the power affirmatively acts to release the power. By giving up the right to make an appointment pursuant to the power, the settlor is treated as if he actually made the appointment and “transferred” the property to the default beneficiary named in the trust. The Code does not have similar provisions for the holders of nongeneral powers of appointment.

Even with a default beneficiary named, a particular beneficiary cannot be certain he will actually receive the property until the testamentary nongeneral power is either exercised or not. Therefore, it is proper to treat these assets subject to such power as continuing as a property interest to the settlor for gift tax purposes, if there are no other limitations on the settlor. The assets subject to the testamentary nongeneral power should also be treated as continuous property interest of the settlor because of the level of

107. Treas. Reg. § 25.2511-2(b) (as amended in 1999). This provision requires the Owner to part with dominion and control over the property and to leave himself no benefit of the transfer. Id.
110. Id. § 2041.
111. See infra note 138 and accompanying text for further discussion.
112. I.R.C. § 2514(b).
113. Id. § 2514(e). This provides that a “lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power.”
115. See id.
116. See id.
control the settlor has retained. Control is a major factor in determining whether an effective transfer has occurred for gift tax purposes.

Even so, at least one transfer made pursuant to the ATA has been validated as a completed transfer for gift tax purposes. In PLR 98-37-007, a request was made to determine whether a proposed transfer made to a trust, pursuant to the provisions of the Alaska trust statutes, was a completed gift for transfer tax purposes. The facts, in relevant part, of the PLR state:

[The] Donor propose[d] to create [a t]rust, to be administered under the laws of [Alaska], for the benefit of herself and her [beneficiaries]. The trustee [would] have sole and absolute discretion to pay . . . part or all of the income and/or principal of [the] trust to Donor and the Donor's living descendants.

The Donor "requested a ruling that the transfer by Donor of property to [the t]rustee to be held under the [t]rust agreement . . . be a completed gift for federal gift tax purposes."

The IRS issued PLR 98-37-007 indicating that the transfer was a completed gift based on the representation that the trustee had "sole and absolute discretion" to pay income or corpus to the donor or any other beneficiary of the trust. Furthermore, the IRS came to this decision based on the fact that there were no express or implied agreements between the donor and the trustee as to how the trustee would exercise his "sole and absolute discretion." For gift tax purposes, a taxable gift has occurred in this situation because the donor presumably gave up complete control and dominion of the trust assets.

In the facts of the PLR, however, there is no mention of a retained power of appointment, general or otherwise. Therefore, this PLR, as the only authority revealing the position of the Treasury Department, offers no protection to settlors seeking to establish a self-settled DAPT with a retained power of appointment for the settlor. This is because the possession of such a power is a substantial change in the position from that of the transferor described in the PLR.

118. Id.
119. Id.
120. Id.
121. See supra note 107.
Therefore, for federal transfer tax purposes, if the donor retains a nongeneral power of appointment, the transfer should not be treated as a completed gift, regardless of whether the power of appointment is exercised. As such, the donor should still be deemed as having a sufficient property interest in the property despite the fact that creditors are denied access to the trust funds to satisfy their claims under state law. It is important to note that within PLR 98-37-007, the IRS specifically refused to take a position regarding the estate tax consequences of this transaction. Since the IRS refused to take a position on whether the facts indicated in the PLR support a conclusion that the property held in a self-settled trust would be included in the gross estate of the decedent, even in the absence of a power of appointment, it is safe to say that the debate is far from over.

Consequently, even with a transfer labeled as a completed gift during the lifetime of the settlor, it does not end the discussion of whether the retained interest in that transferred “gift” should be includable in the gross estate of the settlor for estate tax purposes. The next section of this Article will discuss possible estate tax consequences for a donor who has transferred property to an APT and retained powers authorized by the ATA.

C. Estate Tax Implications

1. Comparison to the Gift Tax

While many may use the term “estate and gift tax” as if the two taxing systems are one in the same, a better explanation is to say the two taxing systems are on opposite sides of the same coin. One purpose of the estate tax is to raise revenue while combating wealth concentration. One purpose of the gift tax is to serve as a backstop to prevent persons from avoiding the estate tax by giving away all of their property while on their deathbeds. As a result, an evaluation from an estate tax perspective is different from an evaluation of the gift tax; as a consequence, the same property that may have been the subject of a purported inter vivos gift may also be the subject of analysis for inclusion in a decedent’s gross estate for estate tax purposes. For the estate tax analysis, the focus is whether the

123. Id. The specific language states, “[w]e are expressly not ruling on whether the assets held under the Trust agreement at the time of Donor’s death will be includable in Donor’s gross estate for federal estate tax purposes.” Id.
125. Marty-Nelson, Taxing Offshore Asset Protection Trusts, supra note 8, at 419.
decedent had *any* interest in property. That taxable property interest ranges from a right to make decisions about the property to actually exercising a reversionary interest in the property and re-vesting the property in the settlor.

As a result, in evaluating the taxability of a particular transfer, the different property interests must be addressed individually. As previously mentioned, one of the provisions under the Alaska statute authorizes the settlor to draft an instrument granting himself a testamentary nongeneral power of appointment. Such a power does not subject the property that is the subject of that power to the claims of the settlor's creditors.

2. Possession of a Power of Appointment

While possession of a testamentary nongeneral power of appointment protects the property from creditors in the State of Alaska, possession of such power will almost certainly, and should, cause inclusion in the gross estate from an estate tax perspective. Usually a person who holds a general power of appointment will be subject to taxation under §2041, whether or not the power is actually exercised. Ordinarily, the mere possession of a general power of appointment is an interest in property. For estate tax purposes, the right to decide who will enjoy the beneficial interest in property is enough of a property interest to require inclusion in the gross estate of the power holder.

Referring back to the provisions in the Alaska statute, the statute permits a donor to grant himself a nongeneral power of appointment. It is worth noting that the IRC was drafted to deal with third parties who are granted a power of appointment by a settlor, not settlors who grant themselves such powers. This makes sense because it would be unnecessary for the settlor to appoint himself a power to make decisions regarding property that he previously owned simply because the property is held in a trust. The settlor would simply retain the property if he was not ready to part with it. The property, therefore, should properly be taxed under the provisions of §2033 as an interest in property if the property is not ultimately transferred.

Therefore, despite the label that the Alaska legislators attach to the property interest, if the settlor retains a testamentary nongeneral power of

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127. ALASKA STAT. §§ 34.40.115, 34.40.110(b) (2008).
128. See I.R.C. § 2041. Section 2041 provides a definition of a general power of appointment for estate tax purposes which is, in relevant part, a power exercisable in favor of the individual possessing the power, his estate, or the creditors of his estate. Id.
129. Id. § 2036(a).
130. See id. § 2033.
appointment in the trust property, the fact of the matter remains that the settlor still has some level of control, though diminished, of the trust property subject to such power after the transfer. For that reason, the property subject to such power should continue to be treated as a property interest of the settlor. Consequently, if James Smith retains a testamentary nongeneral power of appointment over the assets in his trust, the trust property may well be protected from his creditors from a state law property. On the other hand, for purposes of the federal transfer tax system, the property subject to that power should be deemed as a property interest held by James; therefore, possession alone of such a power should be enough to cause the property subject to the power to be included in his gross estate for estate tax purposes.

To permit the settlor to pretend that the property subject to the testamentary nongeneral power of appointment in his DAPT is not really an asset under his control is unjustified and patently unfair. For example, James has $5 million in assets prior to establishing his self-settled DAPT. Assume asset protection is as high a priority as tax savings, further assume that he funds the trust with $3.5 million of his wealth. Though the transfer will be subject to a gift tax, James now has the ability to accumulate more wealth while shielding the $3.5 million not only from his own creditors, but also from the creditors of the other beneficiaries named in the trust while still possessing the right to decide who will ultimately possess the property.\(^{131}\)

To then pretend that the settlor has no such power for the purpose of subjecting the property to estate taxation is disingenuous. The Ninth Circuit’s treatment of the Andersons as owners of a self-settled trust in \textit{FTC v. Affordable Media, L.L.C.} is an excellent example of how such a transaction should be analyzed, even though the facts of that case surrounding the taxpayers are in the extreme.\(^{132}\) The court focused on the totality of the circumstances, instead of the actual terms of the trust agreement, in deciding how best to view the powers retained by the settlor.\(^{133}\)

If we return to our facts with James Smith, the focus should be centered on his retained control over the transferred property. Whether or not James actually exercised the testamentary nongeneral power, the fact

\(^{131}\) The first million dollars will be subject to the gift tax, though no transfer tax will be due for that amount. For that amount that exceeds the first million, two and a half million dollars, would be subject to the gift and that transfer tax would be due for that taxable year.

\(^{132}\) 179 F.3d 1228, 1242-44 (9th Cir. 1999).

\(^{133}\) \textit{Id.} ("Given that the Andersons’ trust is operating precisely as they intended, we are not overly sympathetic to their claims and would be hesitant to overly-restrict the district court’s discretion, and thus legitimize what the Andersons have done.").
that he could exercise the power brings uncertainty to the beneficiaries as to whether they will actually receive any part of the trust funds. As such, the property should be included in the estate of the power holder, i.e., James, notwithstanding the labels and definitions attached to the transaction.

As previously mentioned, § 2041 does not specifically address the consequences of a settlor’s retention of a nongeneral power of appointment by a settlor. It is appropriate to consider whether § 2033 provides the applicable authority for including the property subject to such power in the settlor’s gross estate for estate tax purposes because one could argue that the settlor never really released this property from his power.134 If the settlor is successful in excluding the property from his gross estate for estate tax purposes, the settlor’s release of his nongeneral power of appointment over the property while on his deathbed would not subject the property to the three year look back period under § 2035.135 By analyzing the specific purpose of the nongeneral power, it appears that §§ 2036 and 2038 would also encapsulate the powers retained by a settlor under the title of a nongeneral power of appointment and indeed more appropriately subject property to inclusion in the settlor’s gross estate for estate tax purposes.136

It is appropriate to consider the powers available and the property interest in the nongeneral power of appointment.137 Under normal circumstances, where James establishes a trust for the benefit of a third party, the easy solution to circumvent the tax problems associated with possession of a general power of appointment is to grant the appointee a nongeneral (special) power. Where a third party beneficiary is the holder of a special power of appointment, the beneficiary does not possess a sufficient interest to cause inclusion of the property in his gross estate at death.138

In determining whether the estate tax is applicable to a transfer of property to a DAPT, where the grantor retains a special power of appointment, §§ 2036, 2038, and 2041 must be explored.139 Section 2041,

135. See I.R.C. § 2035(b).
136. See id. §§ 2036, 2038.
137. See Treas. Reg. § 20.2041-3(c) (as amended in 1997). Only the possessor of a general power of appointment would have this interest included in his gross estate for estate tax purposes. A power is not a general power if it is exercisable only in favor of one or more designated persons or classes other than the appointee or his creditors, or the appointee’s estate or the creditors of his estate.
138. Nongeneral powers are also known as limited or special powers.
139. See generally I.R.C. §§ 2036, 2038, 2041.
as previously discussed, clearly applies to possessors of a general power of appointment, but not where the donor of the power attempts to appoint himself as a general power holder. Section 2041 also does not provide for inclusion of the assets subject to a special power of appointment for those in possession of such a power.

The Code reflects the fact that Congress believes individuals possessing a special power of appointment do not possess sufficient power to be treated as owners of the property; therefore, possession of such power is not subject to taxation.\(^{140}\) Perhaps the simple solution for a settlor is to grant himself a special power of appointment. In this regard, at least one of the permissible beneficiaries will have some level of assurance that he will receive a benefit from the trust. This is due to the power holder's limited decision making capacity regarding to whom he can choose to pass the trust property. If we accept the terminology and definitions of the Alaska statutes, then the analysis ends here. The tax treatment of a true special power of appointment was addressed by the Code and specifically exempted from inclusion for estate tax purposes.\(^{141}\)

The Treasury Regulations state that if a donor retains a testamentary nongeneral power of attorney to appoint the trust property to beneficiaries among the donor’s descendants, no portion of the trust is considered a completed gift.\(^{142}\) The author asserts that by defining the special power as a testamentary nongeneral power of appointment, the ATA is attempting to provide the appearance that the trust has been completely transferred before death, and then permits a testamentary act by the decedent which results in the ultimate transfer of the trust property at the death of the decedent. Thus, a transfer of property to a trust, whereby a special power of appointment is retained by the donor, should not result in a completed gift at the time of the transfer when the power is retained by the settlor within the trust provisions of a self-settled trust.

Since the donor does not have the right to exercise this power during life, the only way to convert this transaction into a completed gift during life is to relinquish the special power of appointment.\(^{143}\) In the event the donor dies during the three years after such relinquishment, § 2035\(^{144}\) would then cause inclusion in the gross estate of the donor if the property would have been subject to the provisions of IRC §§ 2036 and/or 2038.

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140. See supra note 138.
141. There is no taxing authority that would authorize taxation to the holder of a special power of appointment.
143. By releasing the retained power, the donor has not given up the remaining power held over the transferred property and such transfer would not be deemed a completed gift.
144. I.R.C. § 2035.
On the other hand, the special power of appointment contemplated by the Code was a power bestowed upon a third party by the donor, not a power that the donor granted to himself. Therefore, by definition, the special power retained by the donor in accordance with the authority granted by the ATA should not be treated as a special power deserving special tax treatment under the Code. When the power is created by the donor and vested in himself, the fact remains that the donor dictated the terms; regardless of gift tax consequences, the donor retained a property interest over the trust property after the transfer. As such, possession of such a power by the donor should cause inclusion in the donor's gross estate.

A similar situation was further addressed in PLR 2002-47-013 where a donor sought a ruling regarding inter vivos transfers to an irrevocable trust where he retained a special testamentary power of appointment. The IRS took the position that by reason of the donor's special power of appointment, the donor maintained the ability to change beneficiaries of the trust, and thus possessed dominion and control over the trust property; therefore, the transfer was not deemed completed for gift tax purposes. Consequently, this property was includable in the donor's gross estate at death.

Next, to determine whether assets of a self-settled DAPT subject to a special power of appointment should be included in the gross estate of the decedent, a careful analysis of IRC §§ 2036 and 2038 is warranted. In general, § 2036 requires the value of the decedent's gross estate to include property when the decedent's transfer possess the following features: (1) a transfer is made; (2) in trust or otherwise; (3) where the transferor retains the right to use, possess, or enjoy the property; and (4) for his lifetime or time period which does not end before his death. An additional property interest included under § 2036 is whether the transferor possesses the right to determine who shall enjoy or possess the property at the time of the transferor's death.

By retaining a special power of appointment, a donor will not likely cause inclusion of his trust assets in his gross estate under § 2036(a)(1). Inclusion also will not be warranted based on a donor's possession of a

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145. I.R.S. Priv. Ltr. Rul. 2002-47-013 (Nov. 22, 2002). The IRS also stated its position in PLR 2001-48-028 that under section 2514, only the exercise or release of a general power is subject to tax. I.R.S. Priv. Ltr. Rul. 2001-48-028 (Aug. 27, 2001). However, when a person transfers property and retains a special power to appoint to others, the person's special power of appointment is enough dominion and control to treat the transfer as an incomplete gift.
146. I.R.C. § 2036(a).
147. Id. § 2036(a)(2).
special power of appointment because this retained power will not be
considered a retained interest to possess or use the property for life.\textsuperscript{148} By
retaining a special power of appointment, a donor’s trust property may be
subject to estate tax inclusion under § 2036(a)(2).\textsuperscript{149} Returning to the
scenario with our client, James Smith, for a moment, his retention of a
special power of appointment is likely to affect inclusion of the trust assets
in his gross estate. At a minimum, possession of special power of
appointment gives him the testamentary right to designate who will enjoy
the property after his death.\textsuperscript{150} This possession of a right to decide who will
possess the property should cause inclusion in the gross estate pursuant to §
2036(a)(2). This is because even with a special power of appointment,
which limits the possessor to making an appointment within a specific
group or entity, the power holder still possesses the right to decide who
amongst the group or entity will receive the property.

While § 2036(a)(2) provides enough support to cause inclusion in the
gross estate, further support involves the applicability of § 2038.\textsuperscript{151} Section
2038\textsuperscript{152} generally requires the value of the gross estate to include property
of which the decedent has made a transfer, in trust or otherwise, where the
power to alter, amend or revoke is subject to change by the decedent alone
or in conjunction with someone else, on the date of the decedent’s death.\textsuperscript{153}

Sections 2036 and 2038 generally work together in order to prevent a
person from transferring property to a trust and retaining the use or
enjoyment of, or the authority to make decisions regarding, the trust
property while also escaping estate taxation. The sections then prevent a
person from avoiding a transfer tax at death because he did not technically
“own” the property at the time of death. To determine whether these code
sections are applicable, the pertinent powers available under the provisions
of the ATA statute will be stated and Code §§ 2036 and 2038 will be
individually applied to those provisions where applicable. Under § 2038,
the gross estate includes property where the decedent, who was also the
donor of the trust, retained an interest whereby the enjoyment of that

\begin{flushleft}
148. Id. § 2036(a)(1).
149. Id. § 2036(a)(2).
phrase ‘right to designate the person or persons who shall possess or enjoy the transferred
property or the income therefrom’ includes a reserved power to designate the person or
persons to receive the income from the transferred property, or to possess or enjoy
nonincome-producing property” for the proscribed period. Id.
151. I.R.C. § 2038.
152. Id.
153. Id. § 2038(a)(1).
\end{flushleft}
property was subject to change on his date of death, whether that power was alone or in conjunction with another person.\textsuperscript{154}

While the donor has not specifically retained the right to change the enjoyment of the trust, he nonetheless possesses that right by retaining a testamentary special power of appointment. For example, if James were to exercise a testamentary special power of appointment, special through his will, he may appoint the property to one or both of his children. Therefore, he decides who will ultimately possess or use the property.

As long as the donor possesses the right to exercise a power of appointment, that power should be treated as a retained power that affects inclusion in his gross estate. In a careful analysis of the statute, despite the fact that the donor has an irrevocable trust, § 2038(a)(1)\textsuperscript{155} may result in estate tax inclusion if the donor retains a special power of appointment because he essentially retains the right to alter or amend a beneficiary's interest in the trust. The IRS utilizes a "substance over form" approach which readily demonstrates that the donor's retained power to alter provokes inclusion of the donor's trust assets in his gross estate.

So far, a brief analysis of the estate and gift tax implications lead to the conclusion that estate tax consequences are likely to result from the retention of a special power of appointment retained by the settlor if this power is included in the trust instrument. Although there are times when a settlor may decide to intentionally cause assets to be included in his gross estate for estate planning purposes, there should not be a policy that encourages or otherwise supports the position that a settlor may enjoy the benefits of his trust property, and then pretend that the property belongs to another when he is no longer in a position to enjoy it himself.

V. Delaware Qualified Dispositions in Trust Act ("QDTA")\textsuperscript{156}

A. Comparison to the ATA

Delaware's QDTA was enacted in July 1997, just a few months after the ATA was enacted.\textsuperscript{157} Delaware's QDTA has similar features to that of the ATA in that it also permits the settlor (transferor)\textsuperscript{158} to establish

\begin{itemize}
\item \textsuperscript{154} See id.
\item \textsuperscript{155} Id.
\item \textsuperscript{156} Del. Code Ann. tit. 12, § 3570 (2007).
\item \textsuperscript{157} 1997 Alaska Sess. Laws 006. The ATA was enacted on April 2, 1997.
\item \textsuperscript{158} Del. Code Ann. tit. 12, § 3570(10) (2007). The statute defines transferor as a person who, as the owner of the property, as a holder of a power or appointment which authorizes the holder to appoint in favor of the holder, the holder's creditors, the holder's estate or the creditors of the
\end{itemize}
spendthrift provisions within the irrevocable trust instrument, permits discretionary payments to the settlor, and permits the settlor to hold a power of appointment. The Delaware QDTA, as well as the ATA, each provide for exclusive jurisdiction for challenges as to the "validity, construction and administration of the trust[s]" in the relative state jurisdictions.

There are also some statutory provisions that are not included in the ATA. First, section 3573 provides limitations on qualified dispositions with respect to certain specified creditors. Section 3570(7) provides a definition of a "qualified disposition," which is a "disposition by or from a transferor to a qualified trustee or qualified trustees, with or without consideration, by means of a trust instrument." Therefore, there is a special category of creditors who may be authorized to make a valid claim against the trust. The circumstances under which these creditors may make a valid claim, and the application of the provision, are very limited.

One of the limited exceptions for creditor access is based on whether there is a court order for child support or alimony. If the basis for making the transfer to the trust is to avoid paying a child support or alimony obligation, then the transfer to the trust will not be protected, at least to the extent that the funds are needed to satisfy the obligation. The other exception provides for creditor access to the trust to satisfy a claim where a person "suffers death, personal injury or property damage" as a result of the settlor’s action or inaction.

Referring back to our example in which James wishes to seek asset protection against future creditors even where the liability may be due to holder’s estate, or as a trustee, directly or indirectly makes a disposition or causes a disposition to be made.

Id.

159. See id. § 3570(11)(c).
160. Id. § 3570(11)(b)(3).
161. Id. § 3570(11)(b)(2).
162. See id. § 3570(11)(a); see also ALASKA STAT. § 13.36.035(c).
163. See Del. Code Ann. tit. 12, § 3573(1) (including as special creditors "any person to whom the transferor is indebted on account of an agreement or order of the court for . . . support or alimony [payment] to spouse [or] former spouse" and child support to the extent of these obligations); see also id. § 3573(2) (stating the other creditor with this special exemption is "any person who suffers death, personal injury or property damage" as a result of transferor’s actions or omissions before the date of the transfer to the trust, assets to satisfy this obligation are available to the extent of the obligation).
164. Id. § 3570(7).
165. Id. § 3573(1).
166. See id.
167. Id. § 3573(2).
his own fault, in the instance where he causes injuries to a victim in a car accident, or commits some other tortious act such as malpractice, James may rest assured that the assets he transfers to the trust will still be protected from a judgment against him unless the transfer is perceived as a fraudulent transfer. Even if he causes the accident and the victim suffers serious bodily harm, James's trust assets will still be out of the reach of the court since the accident will have occurred after the date the trust was established and settled subject to the fraudulent transfer provisions. On the other hand, if the tort claim were a valid qualified disposition where the statute provides creditor access, even under these limited circumstances, the self-settled DAPT may be more vulnerable to inclusion in the gross estate for estate tax purposes if there is a pattern of permitting creditor access on a number of occasions for predictable claims such as those associated with malpractice or reckless driving. As previously discussed, if assets are subject to claims of the settlor's creditors, then the transfer of property to an irrevocable inter vivos trust may not constitute a completed gift. \(^{168}\)

B. Estate and Gift Tax Consequences for the Settlor as Trust Advisor

Second, Delaware's QDTA provides the settlor the opportunity to appoint himself as a trust protector or trust advisor. Specifically, section 3570(8) provides for the settlor to appoint himself as the trust protector or advisor, which permits him to appoint and replace trustees. \(^{169}\) Section 3570(8)(c) provides that:

\[\text{[N]either the transferor nor any other natural person who is a nonresident of this State nor an entity that is not authorized by the law of this State to act as a trustee or whose activities are not subject to supervision as provided in paragraph a. of this subsection shall be considered a qualified trustee; however, nothing in this subchapter shall preclude a transferor from appointing one or more advisers, including but not limited to: 1. Advisers who have authority under the terms of the trust instrument to remove and appoint qualified trustees or trust advisors; 2. Advisers who have authority under the terms of the trust instrument to direct, consent to or disapprove distributions from the trust...} \]

\(^{168}\) Rev. Rul. 76-103, 1976-1 C.B. 293. "The transfer of property to an irrevocable inter vivos trust created in, and administered under the laws of, a state in which the trust is deemed a 'discretionary trust' whose assets are subject to claims of the grantor's creditors, does not constitute a completed gift." \(^{169}\) Del. Code Ann., tit. 12, § 3570(8)(c). This provision states:
3570(8) provides a definition of a qualified trustee. A qualified trustee must arrange and maintain custody of some or all of the qualified disposition trust property for a valid trust.

A trust advisor has the power under the statute to remove and appoint qualified trustees, and if the trust instrument allows, the trust advisor may "direct, consent to or disapprove distributions from the trust." In order to properly analyze this provision we must cross-reference with section 3570(8)(a) and determine if the transferor can be a proper "qualified trustee." This provision specifically prohibits the transferor from being named as a qualified trustee if he is a non resident.

On the other hand, possessing the power to remove and appoint qualified trustees in a self-settled trust appears to give the settlor the indirect power to control distributions. Presumably, by controlling the trustee, the trust protector may control distributions. With such a power, should the settlor then be considered the de facto trustee? The position of trust advisor appears to give the settlor the type of dominion and control that ordinarily disqualifies the transfer as a completed gift. The settlor is never in any real danger of not having access to the funds should it become necessary in his future to gain access to such funds.

For estate tax purposes, retention of a power by the donor of a power of appointment again requires an analysis under §§ 2036 and 2038 with respect to the retained power. In a similar transaction, the IRS took the position that a trustee's power should be attributed to the donor because the power to fire the trustee likely causes the trustee to bend to the donor’s will. The IRS's attempts to defend this position failed in the courts. For example, in *Estate of Wall v. Commissioner,* a settlor created an

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170. See id. § 3570(8)(a). A qualified trustee is defined as a natural person, resident of the state of Delaware, authorized by law to act as trustee and subject to the supervision of "the Bank Commissioner of the State and the Federal Deposit Insurance Corporation, Comptroller of Currency, or the Office of Thrift Supervision or any successor thereto." Id.

171. See id. § 3570(8)(b).

172. Id. § 2570(8)(c).

173. See id. § 3570(8)(a).

174. See id. § 3570(c).


176. Id. § 2038.

177. Rev. Rul. 81-51, 1981-1 C.B. 458 (revoked by Rev. Rul. 95-58, 1995-2 C.B. 191). In this revenue ruling the IRS maintained the position that the power to remove and replace the trustee was a retained power that caused the trust property to be includable in the gross estate under §§ 2036(a)(2) and 2038(a)(1).

178. 101 T.C. 300, 301-02 (1993). The issue in this case was "whether property held by three irrevocable inter vivos trusts created by the decedent, Helen S. Wall (Mrs. Wall), . . . [was] includable in her gross estate under [§] 2036(a)(2) or [§] 2038(a)(1) because in
irrevocable trust and retained the power to remove the trustee and appoint another corporate trustee. The court held that because a trustee owes a fiduciary duty to the beneficiaries of the trust, not to the settlor, the court would not presume that the trustee would behave counter to his fiduciary duty.\footnote{Id. at 313.}

The IRS acquiesced to this ruling in Revenue Ruling 95-58, which states that a settlor may retain the power to appoint a successor trustee, as long as the successor trustee is not a subordinate or related party.\footnote{Rev. Rul. 95-58, 1995-2 C.B. 191. The IRS "reconsidered whether a grantor’s reservation of an unqualified power to remove a trustee and appoint a new trustee[,] other than [himself, was] tantamount to a reservation by the grantor of the trustee’s discretionary powers of distribution." Id. The IRS held that possession of the power to remove the trustee and appoint an individual or corporate successor trustee was not enough retained control to be tantamount to control over discretionary distributions of income and to warrant inclusion of the trust assets in the gross estate of the decedent. Id.; see also Estate of Vak v. Comm’r, 973 F.2d 1409, 1410-14 (8th Cir. 1992). In this case, Donor transferred stock to an irrevocable trust and named his son and daughter-in-law as joint trustees. Id. Donor retained the right to remove trustees with or without cause and name successor trustees who were not related or subordinate to Donor. Id. The court held that Donor retained no power to recall the gift and the right to replace Trustee was limited to a right to appoint an independent trustee so the transfer qualified as a completed gift. Id.}

The ruling further stated that holding the power to name a successor independent trustee, without something more, would not be considered a reservation of power over the property subject to taxation.\footnote{Id.}

The Treasury Regulations provide further guidance. The Regulations describe a consequence where the decedent retains the power to remove or discharge a trustee, so such power is treated as a retained right subject to estate taxation.\footnote{Treas. Reg. § 20.2036-1(b)(3) (as amended in 2008) ("If the decedent reserved the unrestricted [right] to remove or discharge the trustee at any time and appoint himself as the trustee, the decedent is considered as having the powers of the trustee.").}

The example provided, however, describes a situation where the decedent removes the trustee and appoints himself instead.\footnote{Id. § 20.2036-1(b)(3).} In reference to our client James Smith, it appears that naming himself as trust protector may be enough to avoid a prohibited retention of power; this may therefore be enough to avoid inclusion of the trust assets in the gross estate for estate tax purposes.

The Delaware statute permits the settlor to have the power to remove a trustee, an important right for someone who has an interest in the trust, while prohibiting the possibility of the settlor having the ability to name creating the trusts Mrs. Wall reserved the right to remove the sole trustee, a corporation, and appoint a successor corporate trustee." Id.
himself, or anyone who is related or a subordinate party\textsuperscript{184} to the settlor, to serve as a successor trustee. Based on the court rulings, revenue rulings, and regulations, it appears that James is allowed to retain the right to remove and name a qualified trustee or trust protector without invoking a transfer tax for gift or estate tax purposes, particularly given the prohibition in the Delaware statutes that prevent him from naming himself or a subordinate party.

On the other hand, these aforementioned regulations and rulings were made in cases that did not involve self-settled trusts. For that reason, the types of trusts involved are not substantially similar in a factual manner because the settlor is also a permissible beneficiary of a self-settled trust. Therefore, these regulations, rulings, and cases should not be applicable precedent to protect the transaction where the settlor retains the right to remove a trustee where he is also a beneficiary of the trust.

The right to remove a trustee or trust protector and replace him with another, even if James is only permitted to appoint an independent trustee or trust protector, should still be treated as a retained power under the same theory applied to the Andersons.\textsuperscript{185} The court looked to the totality of the circumstances regarding the level of control the Andersons possessed by virtue of the trust advisor positions they held in their offshore trusts. Specifically, the court looked to the history of transfers and found that if the Andersons had wanted to repatriate the transfers, then they could have done so.\textsuperscript{186}

While the court did not specifically find that the Andersons possessed a retained power, the court determined that by virtue of holding the position of trust protector over the self-settled trust, the Andersons still had control over the distributions and upheld the contempt charge for failure to comply with the restraining order to repatriate the trust assets.\textsuperscript{187} As such, the settlor who continues to hold the position of trust protector should automatically be treated as having control over the distributions in those cases where he has the right to remove a trustee and appoint a new trustee,

\textsuperscript{184.} DEL. CODE ANN. tit. 12, § 3537 (2007) (citing I.R.C. § 672 (2006)). This provision provides a definition of related and subordinate parties, which means any nonadverse party who is the settlor’s spouse if living with grantor, father, mother, issue, brother, or sister, employee and etc. I.R.C. § 672(c).

\textsuperscript{185.} FTC v. Affordable Media, L.L.C., 179 F.3d 1228, 1242 (9th Cir. 1999).

\textsuperscript{186.} Id. at 1242-43 ("The Andersons had previously been able to obtain in excess of $1 million from the trust in order to pay their taxes. Given their ability to obtain, with ease, such large sums from the trust, we share the district court’s skepticism regarding the Andersons’ claim that they cannot make the trust assets subject to the court’s jurisdiction.").

\textsuperscript{187.} Id. at 1243.
or have any influence or control over distributions; therefore, the transfer to
the trust should not be treated as a complete gift.

Even if the settlor does not retain the position as trust protector, he
should still be treated as having control over the distributions if he were to
retain the right to replace the trustee. While recognizing that the ruling in
Wall is good law, Wall did not involve a self-settled trust, so the settlor was
not also a beneficiary of the trust involved. When the settlor is also a
beneficiary, the trustee should find it more difficult to say no to a settlor’s
request for a distribution when he realizes that he could be replaced if he
denies such requests. When the settlor is not a beneficiary of the trust, the
trustee may still be reluctant to act contrary to the settlor’s “wishes,” but
the pressure the trustee may feel is different and not subject to the same
type of reasoning that a trustee may feel in denying a distribution to the
settlor of the settlor’s “own money.” As such, the right to remove a trustee
in a self-settled trust should be treated as a retained right to control
distributions. As previously mentioned, by controlling the transfers through
the position as the trust protector, or by controlling the trustee with the
“Sword of Damocles,” the retention of the right to replace a trustee in a
self-settled APT should be treated as a retained right subject to taxation
under § 2036(a)(2) or § 2038 of the IRC.

C. Estate and Gift Tax Consequences for a Settlor with Veto Power

The Delaware QDTA statutes provide for the power to veto a
particular distribution. An analysis of the power to direct, consent, or veto a
distribution gives rise to an analysis of §§ 2036(a) and 2038. With a veto
 provision written into the trust instrument, the transferor retains the power
to determine who will enjoy or possess the property or income from the
trust. The statute does not have restrictions regarding who the transferor
can veto nor any limiting circumstances that restrict his power to veto. In
the Treasury Regulations we find that where a donor makes a transfer,
whether in trust or otherwise, and he reserves any power over the
disposition, the gift may be wholly or partially incomplete, depending on
the circumstances.188

188. Treas. Reg. § 25.2511-2 (as amended in 1999). This regulation states a “gift tax is
not imposed upon the receipt of the property by the donee, nor is it necessarily determined
by the measure of enrichment resulting to the donee from the transfer.” Id. § 25.2511-2(a).
The tax is based on the transfer by the donor and attaches when the “donor has so parted
with dominion and control as to leave him no power to change his disposition, whether for
his own benefit or for the benefit of [others].” Id. § 25.2511-2(b).
An example of tax treatment of a retained power to change beneficiaries was addressed in *Estate of Sanford.*\(^\text{189}\) The Court held that a donor's gift is not complete for gift tax purposes until the donor relinquishes the retained right to change the beneficiaries of the trust.\(^\text{190}\) While a right to veto a distribution is not the same as a right to change a beneficiary, a right to veto will necessarily alter who will receive the property, thereby altering a beneficiary's right to receive the property. 

The regulations further state a gift is incomplete in every instance in which the donor reserves the power to name new beneficiaries, or to change the interest of beneficiaries as between themselves, unless limited by an ascertainable standard.\(^\text{191}\) As mentioned, the Delaware statute, on its face, does not provide any limits to the power to veto. By retaining the power to deny a beneficiary a disposition from the trust, which is an important property right, it is clear that the transferor has not parted with dominion and control over the property to make the transfer to the trust a completed transfer for gift tax purposes.

Also, by naming himself as a trust protector, James Smith may have the power to veto distributions which should cause the transfer to be treated as an incomplete gift, thus likely causing inclusion in the settlor's gross estate. Inclusion is warranted because the settlor has the power to divert the assets away from a particular beneficiary through the exercise of a veto power. This retained power to veto is evidence that the settlor has not parted with dominion and control over the trust property. As such, his interest in the trust property should be included in his gross estate for estate tax purposes.

As previously mentioned, the QDTA statute requires the trust to be irrevocable and subsequently provides a very generous definition of irrevocability.\(^\text{192}\) The statute allows for the "transferor's potential or actual receipt of income, including rights to such income retained in the trust instrument,"\(^\text{193}\) and the "transferor's potential or actual receipt or use of principal if . . . a qualified trustee [is] acting [within his] discretion,"\(^\text{194}\) or

\(^{189}\) 308 U.S. 39 (1939). In this case a taxpayer created multiple trusts for named beneficiaries, other than himself, and reserved the power to revoke the trust and to designate new beneficiaries, other than himself. *Id.* at 41-42.

\(^{190}\) See *id.* at 43-44.

\(^{191}\) Treas. Reg. § 25.2511-2(c).

\(^{192}\) See Del. Code Ann. tit. 12, § 3570(11)(b)(1) (2007) which provides the opportunity for a transferor "to veto a distribution from the trust." Section 3570(11)(b)(2) provides for a testamentary nongeneral power of appointment retained in the transferor within the trust instrument.

\(^{193}\) *Id.* § 3570(11)(b)(3).

\(^{194}\) *Id.* § 3570(11)(b)(6)(A) (emphasis added).
pursuant to a standard that governs [] distribution of principal [that] does not confer upon the transferor a substantially unfettered right to the receipt or use of the principal.

The first aspect for discussion is the transferor’s option to indicate in the trust instrument that he will retain the right to receive income from the trust, but only in accordance with the trustee’s discretion. If the income stream is regular and not limited by an ascertainable standard, the transfer probably will not represent a completed gift because, in viewing the transaction, the transferor has retained a right to receive income after the transfer. In such a situation, the transfer should be treated as a retained interest by the transferor, and not as a completed gift; therefore, it will be subject to estate taxation at the death of the transferor.

The estate tax consequences implicated by a right to receive income and/or principal specified in the trust instrument, as allowable by the QDTA, are distinguished from that of the gift tax. A good place to start the estate tax discussion is with § 2036(a)(1), which includes property where the settlor has retained the right to receive income or principal for his life, a period “not ascertainable without reference to his death or for a period that does not end before his death.” For estate tax purposes, this right to receive or use an income interest, if drafted in to the trust instrument, should cause inclusion under § 2036(a)(1) even if the right is limited by the trustee’s discretion. This is so because the settlor still has a right to receive the income from the trust until the moment of his death—at least that amount that would be subject to the trustee’s discretion, especially if the settlor has the right to remove the trustee.

The same analysis applies to the right to receive and use the principal. If the trustee has the discretion to distribute the entire corpus to the settlor, then the transaction should not be deemed as a completed transfer. The qualification in the statute that the settlor must not have a substantially unfettered right to receipt and use of the trust corpus leaves a substantial amount of leeway for the settlor to retain the right to receipt and use of the principal of the trust. This generous definition of irrevocability is meaningless as stated because it may not apply to a situation where the settlor has mild unfettered rights. Regardless of the degree of substantially similar rights, if the settlor retains those rights in the trust instrument, the

195. Id. § 3570(11)(b)(6)(B).
196. See id. § 3570(11)(b)(3).
property interest should still be treated as his own property until he has completely released dominion and control over such property pursuant to § 2036(a)(1) and (a)(2).\textsuperscript{199}

The estate tax evaluation invokes § 2038(a)(1).\textsuperscript{200} This provision requires the value of all property to be included in a decedent’s gross estate to the extent the decedent made a transfer, by trust or otherwise, where enjoyment was subject to change by a decedent acting alone or with someone else possessing the power to alter, amend, revoke, or terminate or where such powers were released during the three year period preceding the decedent’s death.\textsuperscript{201} This transfer also invokes § 2036(a)(2), which requires inclusion if the donor retains the right to determine who will enjoy the property or the income.\textsuperscript{202} Although Delaware QDTA offers almost unrestricted control over the trust property by allowing the settlor the right to direct or veto a distribution, retain the right to receive income or principal to the trust, retain a testamentary special power of appointment over the property, and while still providing protection against creditor claims if drafted into the trust agreement, a likely consequence of retaining any of these rights is inclusion in the donor’s gross estate for tax purposes.

VI. Nevada Spendthrift Trust Act ("STA").\textsuperscript{203}

A. Comparison to the ATA and Delaware’s QDTA

Nevada is the home of the final self-settled DAPT statute evaluated in this Article. In 1999, Nevada amended its laws to provide for self-settled spendthrift trusts. As with the ATA and Delaware’s QDTA, the Nevada STA trust provides protection from creditors while leaving a certain level of control and benefit to the settlor. To create the self-settled trust in accordance with Nevada’s STA, the trust must meet the following requirements: (1) irrevocability; (2) no requirement to make distributions of any part of the income or principal to the settlor; and, (3) no intention to “hinder, delay or defraud known creditors.”\textsuperscript{204}

The statute further explains that “[a] writing [i]s irrevocable even if the settlor may prevent a distribution from the trust or holds a testamentary special power of appointment,” and the writing does not “require” a

\textsuperscript{199} See id. § 2036.
\textsuperscript{200} See id. § 2038(a).
\textsuperscript{201} See id. § 2038(a)(1).
\textsuperscript{202} See id. § 2036(a)(2).
\textsuperscript{203} NEV. REV. STAT. ANN. § 166.010 (2009).
\textsuperscript{204} Id. § 166.040.
distribution if the settlor may receive it only at the discretion of others.\textsuperscript{205} These provisions are consistent with provisions of the ATA and the Delaware QDTA, except that this statute makes the discretionary provision of the trust the default, even if not mentioned by the instrument. It appears from the language that the statute is designed to provide extra protection to settlors against creditor claims and cover the key provisions under the Code for favorable transfer tax treatment.

B. Voluntary Alienation of Trust Property

The estate and gift transfer tax implications and analysis are essentially the same as previously discussed with Delaware’s QDTA. The interesting tax-related distinction is found in section 166.120, which provides explanations regarding restraints on alienation.\textsuperscript{206} According to this provision, an exception to the normal restraint on alienation is declared “when the trust does not provide for the application for or the payment to \textit{any beneficiary} of sums out of capital or corpus.”\textsuperscript{207} “In such cases, the corpus or capital of the trust estate, or the interest of the beneficiary therein, may be anticipated, assigned or aliened [sic] by the beneficiary voluntarily, but not involuntarily or by operation of law or by any process or involuntarily at all.”\textsuperscript{208}

By making this limited exception contingent upon the fact that there is no provision for any type of payment to any beneficiary of the trust, the statute provides a very narrow window for a beneficiary to voluntarily alienate the corpus. Where there are multiple beneficiaries and the beneficiary making a voluntary transfer happens to be the settlor, then estate and gift tax consequences may evolve from this transaction even though the trust is irrevocable and distributions are fully discretionary by the trustee.

As previously discussed, IRC § 2511 imposes a tax on transfer to a trust by completed gift.\textsuperscript{209} The key to whether a completed gift has been made in such a transaction is establishing whether the transferor actually reserved a right if he did not leave a provision for any payment to a beneficiary. Since the settlor, as a beneficiary, has the power to voluntarily alienate his interest, there is a possibility that beneficiaries, other than the settlor, will not receive any part of the trust.

\textsuperscript{205} Id.
\textsuperscript{206} Id. § 166.120.
\textsuperscript{207} Id. (emphasis added).
\textsuperscript{208} Id.
\textsuperscript{209} I.R.C. § 2511 (2006).
Referring back to our client, James Smith, and applying the STA to his facts, let’s assume James is married and transfers property to the trust naming himself, his wife, and his children as permissible beneficiaries. Assume further that when the instrument is drafted, James excludes any provision for distribution of the corpus. Without a provision for payment of the corpus, James may completely alienate or assign his interest in the property at any time. Furthermore, James has the right to revest beneficial title in himself by alienating the property in favor of one of his creditors or to otherwise satisfy his own financial obligations.210

As a result, §§ 2038 or 2033 would likely cause the trust property to be included in James’s gross estate. Section 2038(a)(1) requires inclusion where the right to alter or terminate is vested in the transferor on his date of death.211 The fact that his right exists under state law because payment of the corpus was not drafted into the instrument should not limit the application of § 2038.212 Section 2033 may also be implicated as it requires the value of all property, to the extent of the decedent’s interest, to be included in his gross estate.213 This provision allows the broadest range of inclusion. The estate includes the value of the decedent’s beneficial interest at the time of death. However, in this type of trust, the decedent’s beneficial interest could very well include the value of the entire trust.

CONCLUSION

The purpose of this Article is to demonstrate the transfer tax implications of self-settled DAPTs. Specifically, in certain situations settlors of such trusts should be treated as the owner of specific property interests for the purpose of determining estate tax liability. By focusing on the level of control that the settlor retains in a given circumstance, the degree of dominion and control retained is evidence that the settlor may not have truly parted with a portion of the property to qualify for treating that portion as a completed transfer for transfer tax purposes.

A transferor who controls a trust by serving as a trust protector, or by retaining a veto power or a nongeneral testamentary power of appointment, continues to exercise the kind of control over the trust property that subjects the property under this control to estate taxation when the settlor dies. Since it is clear that these trusts with these powers are likely to continue to exist, and become even more popular in the foreseeable future,

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211. See I.R.C. §§ 2038(a)(1), 2033.
212. See id.
213. See id. § 2033.
because of the trust market dollars they may bring to states, there are clear policy considerations for applying some uniform tax treatment to these trusts.

First, no person should have the ability to place his assets in trust and establish provisions to avoid both valid claims made against him in a court of law and estate tax consequences at death, unless he has truly parted with the property. The rationale for the rule prohibiting a person from putting his own property in a spendthrift trust with himself as the beneficiary “is that a person cannot put his property beyond the reach of his creditors and still have the use of it for his own personal benefit, but if the money comes from someone else, then the beneficiary’s creditors are not deprived of any property that the beneficiary would necessarily have had.”214

On the other hand, a person earning or inheriting wealth should be able to transfer the property in a manner that would result in paying the least amount of tax. There is nothing illegal about minimizing tax liability, and with proper planning a person should have the ability, within the confines of the law, to protect his assets for family members for as long as possible.

Finally, the state treatment for these trusts should be considered and given deference, where deference is warranted. However, as states continue to enact legislation that gives more control to the settlor, while still treating the property as a separate entity, more scrutiny is required when evaluating these trusts’ provisions for transfer tax purposes. Mindful that the primary goal of these self-settled trusts is asset protection, these trusts permit the settlor to retain a substantial amount of control that should be specifically recognized as a valid property interest for transfer tax purposes.

By enacting laws that allow persons who transfer property to trusts designed to protect the transferor’s property from creditor claims, and still permit the transferor to maintain an interest, state legislators are permitting these persons to essentially “have their cake and eat it too.” While the states benefit from such legislation by means of generated revenue, there is no real benefit to the U.S. Government in foregoing potential revenue from estate taxation. As such, there should be strong support for mandating the inclusion of these particular trust assets in the decedent’s gross estate for estate tax purposes.
