

Coming in from the Cold—Estate Planning Using Alaska Trusts

by Gideon Rothschild

With the recent passage of the Alaska Trust Act (Chapter No. 6, SLA 1997; effective April 2, 1997), (hereinafter sometimes referred to as the "Act"), Alaskans have positioned themselves to attract more than the occasional tourist in search of the midnight sun. The Act is intended to make Alaska the premier jurisdiction for the administration of United States situs trusts, both for creditor protection purposes and for more traditional estate plan-filing goals such as the reduction of estate and generation-skipping transfer (GST) taxes. While various factors make it unlikely that Alaska will breed the next generation of asset protection trusts,⁽¹⁾ the new Alaska Trust Act does pose exciting opportunities for those who are more interested in using the Alaska trust to achieve estate planning goals, rather than for asset protection purposes, *per se*. This article will focus its discussion on those planning opportunities.⁽²⁾

The Act

The Alaska Trust Act has two major features. First, the Act extends application of the common law spendthrift trust rule to settlor-beneficiaries so long as certain conditions are met (generally, so long as the transfer was not a fraudulent conveyance *vis-a-vis* the settlor's current creditors). Second, the Act repeals the common-law rule against perpetuities for discretionary trusts.

Prior to passage of the Alaska Trust Act, Alaska Statutes §34.40.110 provided that a self-settled spendthrift trust was ineffective as against the settlor's creditor. With passage of the Alaska Trust Act, however, this rule has been repealed. Alaska Statutes §34.40.110 now provides that, so long as the settlor has not retained the right to revoke the trust, a self-settled spendthrift trust will be valid even against the settlor's own creditors unless the transfer was intended to hinder, delay, or defraud such creditors (*i.e.*, a fraudulent conveyance) or unless the transfer was made at a time when the settlor was in default by 30 days or more in making a child support payment.⁽³⁾

Prior Alaska law also incorporated the Uniform Statutory Rule Against Perpetuities, by providing that a non-vested property interest was invalid unless it was certain to vest or terminate within no later than 21 years after the death of an individual then living or 90 years after its creation. With the passage of the Act, the Statute was amended to provide that an Alaska trust may continue in perpetuity.

Although the benefits of an Alaska trust are available irrespective of the domicile of either the settlor or the beneficiaries, the inclusion of a simple choice of law clause in the trust instrument will not suffice to make a trust an "Alaska trust" under the Alaska Trust Act. Instead, under Alaska Statutes §13.36.03S(c), four requirements must be met for the laws of Alaska to govern the administration of the trust. First, one of the trustees must be a "qualified person," meaning that one of the trustees must be a trust company with its principal place of business in Alaska, a bank with trust powers with its principal place of business in Alaska, or an individual resident of Alaska. Second, at least some part of the trust assets must be deposited in Alaska, either in a checking account, time deposit, certificate of deposit, brokerage account, trust company fiduciary account, or other similar account located in Alaska. Third, the Alaskan trustee's duties must include both the obligation to maintain trust records and the obligation to prepare or arrange for the preparation of the trust's income tax returns, although neither of these duties must be exclusive to the Alaskan trustee. Finally, part of the trust's administration must occur in Alaska, including physical maintenance of the trust's records in Alaska. This guidance distinguishes the Alaska trust from trusts which may be formed under the laws of those few other domestic jurisdictions wherein the rule against perpetuities, and perhaps the spendthrift trust rule, have been modified or repealed. The guidance derived from the Alaska statute provides a settlor with the requisite assurances that the trust which he or she has created will be respected by both the courts and the Internal Revenue Service as properly governed by Alaska law.

Planning with an Alaska Trust

Whatever the instrumentality, a basic objective of any estate plan is the reduction of transfer taxes. While this goal is undeniably important, it must often be reconciled with the client's concurrent desire to retain control of the assets during his or her lifetime. Unfortunately, Code Sec. 2036 acts as a "Catch-22," making it difficult, if not impossible, to reconcile these divergent goals. Specifically, Code Sec. 2036 generally provides that the value of the transferor's gross estate includes the value of any transferred property over which the transferor has retained the right to possession or enjoyment, or the right to income, for a period not ascertainable without reference to his

or her life.

This Catch-22 may pose a dilemma for many clients, especially those with estates of between, say, three and 10 million dollars. Although such individuals stand to pay a 55 percent marginal estate tax, they may not be comfortable with making the relatively large inter vivos gifts which are necessary to significantly reduce the size of their taxable estates. Most often the problem is that such clients are concerned that their retained wealth may be insufficient in the event of a future financial need. The fact that inter vivos gifts are substantially more tax advantageous than testamentary gifts may not provide sufficient planning impetus in light of the possibility, however remote, of such an emergency.⁽⁴⁾

Prior to the passage of the Alaska Trust Act, there was no domestic jurisdiction wherein a settlor could "retain" the discretionary right to trust income or principal and yet have the transfer considered a completed gift for federal transfer tax purposes.⁽⁵⁾ In fact, most states follow the self-settled trust rule set forth in the Restatement (Second) of Trusts §156. Specifically, this self-settled trust doctrine provides that "[w]here a person creates a trust for his own benefit, a trust for support or a discretionary trust, his creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit." Since Alaska now provides creditor protection to a qualifying trust notwithstanding the settlor's right to receive discretionary distributions, settlors who need (or believe that they need) to retain the right to discretionary trust distributions can now do so and at the same time have the assets excluded from their taxable estates and protected from their creditors.

Clearly, if the settlor had retained the right to mandatory distributions from the trust, the transfer would be brought back into the settlor's estate under Code Sec. 2036(a)(1). Furthermore, where a settlor's creditors can reach the settlor's interest in the trust under local law, the trust property would be included in the settlor's estate because he or she has, at least indirectly, retained the "use and enjoyment" of the transferred assets.⁽⁶⁾ In the same vein, however, "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 under the rules set forth in §25.2511-2 of the regulations."⁽⁷⁾ In order that a transfer to an Alaska trust be considered complete for gift tax purposes, the trust must meet the requirements under the Alaska statute and not run afoul of the Internal Revenue Code provisions in that regard. Specifically, the trust must be irrevocable and the settlor must not retain any right to control the disposition of trust property during his life or upon his death. In addition to an Alaska resident trustee, which is required under the statute, the settlor may wish to appoint a local trustee to act as investment trustee or to make distribution decisions. However, it is suggested that the trustee(s) should not be subservient to the settlor

An Alaska trust could typically be established through an inter vivos transfer of the maximum amount exempt under the unified credit and/or the annual gift tax exclusion. Although federal gift tax would have to be paid on any inter vivos transfer in excess of the exemption amount, the tax benefits inherent in inter vivos giving should nevertheless warrant such a transfer, especially for amounts covered by the GST tax exemption. Since the trust instrument would provide the trustees with the discretionary power to distribute trust income or principal to the settlor, whether limited by a particular standard or for any purpose, the size of the transfer need no longer be constrained by the settlor's fear of a future emergency need. In fact, since the transferred assets would be afforded a greater degree of creditor protection subsequent to the transfer than they had while in the transferor's own name, the transfer to an Alaska trust may even enhance the likelihood that the assets will be available to the settlor in case of future need.

Even without the addition of "bells and whistles," an Alaska trust harmonizes the client's goal of estate and GST tax reduction. Due to Alaska's repeal of the rule against perpetuities, the allocation of the settlor's GST tax exemption to a perpetual trust may effectively exempt the entire trust principal from further transfer tax. So long as the assets are retained in trust. As the generations pass, a larger and larger relative portion of the assets will be available to the settlor's descendants than would have been the case had the assets not been transferred until death. For example, if a client funds a trust with \$1 million dollars, allocating his entire GST tax exemption, and the trust earns a 10 percent annualized return, at the end of 25 years the trust will have grown to in excess of \$10 million dollars. This entire corpus will be exempt from any further transfer tax when ultimately distributed to his descendants. If, on the other hand, the client died in 25 years without making the transfer, only \$4.5 million dollars would be available to his heirs after estate taxes, of which only a portion would be exempt from GST tax. Although the same estate tax reduction could be achieved by a gift of the GST tax exemption amount to a non-Alaska inter vivos generation-skipping trust, the client would not be able to remain a discretionary beneficiary. Moreover, the fact that very few domestic jurisdictions other than Alaska permit a trust to continue in perpetuity means that trust assets would again be subject to transfer taxes within two or three generations.⁽⁸⁾

In conjunction with the perpetual duration of an Alaska trust, precatory direction could be given to the trustees that, whenever feasible, property should be retained for the benefit of the trust beneficiaries rather than distribute the property out to the beneficiaries for a similar purpose. Such a clause could instruct the trustees, for example, to purchase a home for a beneficiary's use during his or her lifetime rather than distribute the funds out to the beneficiary for a purchase in his or her own name. Retaining the property in trust will avoid transfer taxes in the beneficiaries' estates, and afford protection from creditors. In addition, once the settlor dies, any accumulations of income will not be subject to state income tax,⁽⁹⁾ although trust income which is distributed out to the beneficiaries would be subject to whatever state and local income taxes to which they are subject.

As noted above, an additional benefit of retaining the assets in trust is the continuing creditor protection afforded to the trust beneficiaries (including the settlor). Although a settlor may not consider his descendants to be at risk in this regard, the future is, of course, impossible to predict. Moreover, the spendthrift clause which protects the settlor's descendants' trust interests against the claims of third-party creditors similarly protects them against the claims of an ex-spouse.

A settlor can also retain control of the assets transferred to an Alaska trust by combining the Alaska trust with a family limited partnership or limited liability company. The limited partnership interest would be assigned to the trust. The settlor would retain the one percent general partner's interest, thereby retaining control of the partnership and the transferred assets held therein, until actual distribution to the trust. Moreover, this structure has two additional benefits; first, both the partnership interest may be valued at a discount due to lack of marketability and control; and, second, the limited partnership structure adds an additional layer of creditor protection to the assets.

Finally, a "checks and balances" system can be created through the inclusion of a trust protector to guard against inappropriate action (or inaction) by the trustees. Although the settlor should generally not be made the protector of the trust, an independent trust protector can be designated with the authority to discharge the trustees and appoint a successor.

The Alaska trust structure can also be useful in other trust applications. For example, the settlor can remain a discretionary beneficiary of a GRAT or QPRT after its initial term ends, provided the trust is governed by Alaska law. In this manner, the grantor can have some peace of mind that the assets are available to him if his financial circumstances change.

Conclusion

Just as corporations are often formed under the laws of other states to obtain the benefit of a more favorable corporate body of law, trusts need not be created under the laws of the settlor's domicile. In the past, if an individual were not interested in settling a foreign situs trust, it hardly mattered what domestic jurisdiction was chosen because there was little variance among domestic trust laws. With the passage of the Alaska Trust Act, however, clients can now reap the substantial benefits which were previously only available in foreign jurisdictions. While an Alaska trust may not be the answer for every client, its impact will assuredly be felt well beyond Alaska.

Reproduced with permission from CCH's Journal of Financial and Estate Planning published and copyrighted by CCH INCORPORATED, 2700 Lake Cook Road, Riverwoods, IL 60015

¹ From an asset protection perspective, Alaska is generally inferior to selected off-shore jurisdictions for several reasons. In the first instance, under the doctrine of comity and the full faith and credit clause of the United States Constitution, Alaska's courts are bound to enforce judgments rendered in its sister states. In contrast, the statutes of several off-shore jurisdictions expressly provide that foreign judgments are not recognized. Additionally, compared to selected off-shore jurisdictions, Alaska has a relatively long statute of limitations for fraudulent conveyance claims. For a more in depth discussion on the use of Alaska Trusts in asset protection planning, as well as the comparative merits of foreign situs asset protection trusts, see Hompesch, Rothschild and Blattmachr, *Alaska Trusts: Something New in the Asset Protection Arsenal*, Journal of Asset Protection (July/August 1997).

² On July 9, 1997, Delaware amended its trust laws to allow creditor protection for self-settled trusts. However due to differences in its statutory provisions, the author believes that the estate planning benefits outlined in this article may not be accomplished using a Delaware trust.

³ In connection with repeal of the common law spendthrift trust rule, Alaska Statutes §34.40.110(d) also now provides that an action by a creditor on a fraudulent conveyance claim must be brought within the later of four years of the transfer or one year after the transfer is or reasonably could have been discovered by the creditor.

⁴ Inter vivos gifts are more tax advantageous than testamentary gifts in part because the gift tax, unlike the estate tax, is computed on a tax-exclusive basis and any subsequent appreciation is removed from the donor's estate. The obvious detriment to an inter vivos gift is the "carry-over" basis acquired by the donee under Code Sec. 1015. Nevertheless, the tax differential between the maximum 55% estate tax rate and the capital gains tax rate salvages much of the tax benefit otherwise provided by an inter vivos gift.

⁵ See, however, Missouri Revised Statutes §456.080, which may allow the creation of asset protection trusts for the discretionary benefit of a class which can include the settlor. Unlike the Alaska, however, the Missouri statute provides no statutory guidance to non-domiciliaries wishing to establish such trusts.

⁶ See, e.g., *F. Paxton*, 86 TC 785, CCH Dec. 43,021 (1986); *M. Outwin*, 76 TC 153, CCH Dec. 37,645, acq., 1981-2 CB 2 (1981); *A. Paolozzi*, 22 TC 182, CCH Dec. 20,636, acq., 1962-1 CB 4 (1954) ("petitioner's creditors could at any time look to the trust of which she was settlor-beneficiary for settlement of their claims to the full extent of the income thereof. This being true, it follows that petitioner . . . could at any time obtain the enjoyment and economic benefit of the full amount of the trust income").

⁷ Rev. Rul. 76-103, 1976-1 CB 293.

⁸ Delaware, Idaho, South Dakota and Wisconsin have also abolished the common law rule against perpetuities.

⁹ Alaska does not impose a state income tax.

MOSES & SINGER LLP

Disclaimer

Viewing this document or contacting Moses & Singer LLP does not create an attorney-client relationship.

This document is intended as a general comment on certain developments in the law. It does not contain a complete legal analysis or constitute an opinion of Moses & Singer LLP or any member of the firm on the legal issues herein described. This document contains information that may be modified or rendered incorrect by future legislative or judicial developments. It is recommended that readers not rely on this general guide in structuring or analyzing individual transactions or matters but that professional advice be sought in connection with any such transaction or matter.

Attorney Advertising

It is possible that under the laws, rules or regulations of certain jurisdictions, this may be construed as an advertisement or solicitation.

Copyright © 2010 Moses & Singer LLP
All Rights Reserved