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Estate Tax Savings With Self-Settled Trusts

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In the authors' first article, "Planning With Spendthrift Trusts,"[1] planners were urged to consider the use of trusts as the preferred estate planning vehicle because of the efficacy of those trusts in protecting beneficiaries from the claims of their creditors.

In the second part of the article, which dealt with self-settled asset protection trusts, the authors expanded upon that asset-protection concept, discussing how certain jurisdictions (mostly offshore) have repealed the traditional "self-settled spendthrift trust" rule. In such jurisdictions individuals can create trusts in which they remain discretionary beneficiaries, with the trust fund nevertheless protected from their own potential future creditors. The benefits that these offshore "asset protection" trusts provide to clients who feel themselves to be "at risk" in today's litigious society is almost incalculable.

Four *onshore* jurisdictions have, to date, repealed the traditional self-settled spendthrift trust rule. Similar legislation has been proposed in at least two additional states. How protective those domestic "asset protection" trusts will be, however, for settlors resident in one of the other 46 states remains to be seen.

Due to a number of factors, not the least of which is the potential effect of the Full Faith and Credit Clause of the U.S. Constitution, many estate and asset protection planners think that those trusts are not ideally suited for asset protection planning, *per se*.

Notwithstanding that fact, however, none of those domestic asset protection jurisdictions was motivated into changing its trust law so as to become an inviolable haven for the nation's debtors. Instead, those jurisdictions sought to take advantage of an interesting interrelationship between the debtor-creditor law and gift and estate taxes so as to attract trust business. Stated otherwise, those states sought to provide a unique opportunity to minimize estate and generation-skipping transfer (GST) taxes through the settlement of an asset protection trust.

Whether created onshore or offshore, self-settled trusts may provide the solution to the age-old fear of running out of one's life savings. As all estate planners know, many clients are reluctant to make substantial gifts during their lifetime because of their need to maintain control and financial security. Both of those competing objectives can be achieved by using the tools that we describe.

Legal Background

Section 2036(a)(1) of the Internal Revenue Code (IRC) provides the general rule for estate tax inclusion:

> The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death ... the possession or enjoyment of, or the right to the income from, the property...

Section 2036(a)(1) reflects a "legislative policy of subjecting to tax all property which has been the subject of an incomplete *inter vivos* transfer."[2] The legislative policy is to include in a decedent's gross estate transfers that are in substance testamentary, i.e., "transfers which leave the transferor a significant interest in or control over the property transferred during his lifetime."[3]

Most instances in which section 2036(a)(1) works to include transferred property in the decedent's gross estate are obvious. For example, that situation occurs when the decedent transfers a bond to her child, but the decedent retains the right to receive the interest that the bond generates. Another obvious example in which Section 2036(a)(1) applies is where the decedent transfers his home to a trust for the benefit of his spouse and children, reserving a life estate for the decedent.

A less intuitive application of Section 2036(a)(1) has led to the inclusion in the decedent's gross estate of the value of property held in a trust in which the decedent retained only a *discretionary* beneficial interest. That inclusion occurs even in cases where the trustee is wholly independent and even where the trustee has an interest in the trust that is adverse to that of the decedent. The fact that the trustee might not ever actually exercise the discretionary power in favor of the decedent does not prevent inclusion.

Legal Reasoning for Rule

The legal reasoning behind the above interpretation of Section 2036(a)(1) was succinctly set forth in *Paolozzi v. Commissioner*.[4] In that case, the Tax Court stated that under Massachusetts law "... 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, as she points out, could at any time obtain the enjoyment and economic benefit of the full amount of the trust income." In accord is *Estate of Paxton v. Commissioner*,[5] in which the court fleshed out that legal reasoning by stating:

> As settlor-beneficiary, decedent retained the economic benefit and enjoyment of the entire trust income and corpus because he could borrow money or otherwise incur indebtedness and relegate his creditors to the trust for payment. Retention of the right to use the trust as a form of security for his indebtedness in this manner left Mr. Paxton with a significant interest in the property ... In our opinion, that is sufficient to require his transfers to the trusts to be included in his gross estate under Section 2036(a)(1).

Property Subject to Creditor's Claims

Clearly, the lynch pin of estate tax inclusion under Section 2036(a)(1) is the fact that the property transferred by the decedent has remained subject to the decedent's creditor's claims under the law of the jurisdiction that governs the trust. Of course, that is the majority rule. As an example, and as noted in the authors' prior article, "Planning with Spendthrift Trusts," section 156(2) Restatement (Second) of Trusts provides that "[w]here a person creates for his own benefit a trust for support or a discretionary trust, his transferee or creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit."

The converse of the foregoing proposition is that where such transferred property is not subject to the claims of the decedent's creditors, it is *not* includible in the decedent's gross estate. The Internal Revenue Service has adopted that result in the gift tax context in Revenue Ruling 76-103, 1976-1 CB 293, wherein the IRS stated:

> 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 section 25.2511-2 of the regulations...

Estate Planning Applications

The ability to transfer property to a trust, retain a discretionary interest in that trust, and yet have the transfer deemed a completed gift for gift tax purposes and excluded from the transferor's gross estate at death is a very powerful estate planning tool. In the authors' experience, the recommendation for clients to effect *inter vivos* transfers of property to or for the benefit of their family have all too often been rejected because of a concern (often unrealistic) that the transferred property may someday be required to maintain the transferor's lifestyle.

The "how much will be enough" dilemma seems particularly prevalent with older clients, most likely because of continuing Depression-era phobias over the potential for catastrophic economic exigencies. That dilemma used to manifest itself most frequently (but not exclusively) with clients with estates of $3 million to $10 million.

With the uncertainty caused by last year's enactment of the Economic Growth and Tax Relief Reconciliation Act, the "how much will be enough" problem has become even more prevalent. Now there is no longer any absolute certainty as to whether a client's estate will, in fact, be taxable if the client does not effectuate some timely *inter vivos* planning.

By suggesting the use of an asset protection trust for estate planning, however, the estate planner can negate (or at the very least significantly assuage) the client's concerns that the transferred property might at a future date be needed if the client's worst fears come to pass. Furthermore, an incidental benefit of a transfer of property to such a trust is that it affords protection against the possibility that a potential future creditor's claim might eradicate the transferor's savings, which might be a form of catastrophic economic exigency that the client might not expect.

The idea of using an asset protection trust to potentially obtain significant estate tax savings can be incorporated into most types of trusts that are used for estate planning purposes. That includes, but is not limited to the following:

1. "Insurance" trusts where the transferor desires to retain the possibility of access to the policy's cash value,

2. Grantor-retained annuity trusts where the client does not want to limit himself or herself to the "estate freeze" value of the retained annuity interest but wishes to potentially benefit from the remainder interest as well and

3. "Crummey trusts" where annual exclusion gifts are made to multiple beneficiaries.

Self-Settled Trust Example

A recent example of the possible applications of the asset protection technique illustrates its utility. A client of the authors had a $6 million estate. The client voiced considerable concern about making outright gifts and the possibility of his future need for the funds. The authors created a self-settled trust under Delaware law that enabled the client, through the use of "Crummey" withdrawal powers, to contribute $320,000 to the trust in each calendar year. The client and his wife were included in the class of beneficiaries, together with their four children, their spouses, and eight grandchildren.

Over a three-year period, the client made gifts of almost $1 million, utilizing an equal amount of his GST exemption but none of his gift tax exemption. As the GST exemption increases, the client can continue to make gift-tax-free contributions to the trust while maximizing the use of his increasing GST exemption so that the trust will continue to have a zero inclusion ratio.

Pitfalls

The IRS has ruled favorably in two private letter rulings, but there remains a lingering uncertainty due to the untested nature of the asset protection legislation in most domestic asset protection jurisdictions and the possibility of future changes in the tax law. Accordingly, planners are urged to build maximum flexibility into those trusts.

For example, if the trust grows significantly and the client becomes less concerned with having the ability to receive distributions, the trustee may be given the power to divide the trust into two trusts. One trust would continue to include the settlor as a discretionary beneficiary, with the attendant risk of possible inclusion, and the other trust would exclude the settlor as a beneficiary.

Conclusion

The benefits of self-settled asset protection trusts, which were not so long ago created almost exclusively by those at risk of creditor claims, are actually more compelling to a broader base of clients as a pure estate and gift tax planning device. That is so because the self-settled trust cuts cleanly through what has long been the Gordian Knot of estate planning. The objective is to reconcile the tax benefits to a client of making *inter vivos* gifts with the client's likely discomfort with transferring property that may someday be required to maintain the client's lifestyle. With a self-settled asset protection trust, the client can effectively "have his cake and eat it, too." The fact that such a trust can now be created in the United States only makes the client's "cake" more appealing.■

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1. Volume 2, Number 7, July 2002.

2. *United States v. O'Malley*, 383 U.S. 627, 631 (1966).

3. *United States v. Estate of Grace*, 395 U.S. 316, 320 (1969).

4. 23 T.C. 182 (1954).

5. 86 T.C. 785 (1986).