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Chapter 10

IRREVOCABLE TRUSTS

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§ 10.1 • INTRODUCTION

Clients may wish to create a trust that is irrevocable for a number of reasons, including: (1) charitable reasons; (2) to remove assets from the client's estate; (3) to protect the assets from the beneficiaries' creditors; (4) to protect assets from the client's creditors; (5) to meet a funding obligation required by a court order, such as a divorce decree that requires a spouse to create a trust for the benefit of children; or (6) to fund corporate obligations, such as for deferred compensation. This Chapter addresses the first four of these reasons. Initially, this Chapter focuses on the general concepts addressed by many irrevocable trusts. The Chapter then delves more deeply into the concepts of: (1) designing trusts to qualify for charitable deductions, to achieve charitable goals, and to allow the client to maintain certain benefits; (2) designing trusts to be "intentionally defective" so that the trust income is taxable to a specific individual; and (3) protecting a person's assets from possible future creditors.

When designing a trust to protect a person's assets from creditors, practitioners should realize that trusts for the benefit of the settlor are void as against the settlor's creditors existing at the time the trust is established.[1] Additionally, a trust may be void as against any subsequent creditors regardless of the existence of any intent to defraud or a spendthrift provision.[2]

§ 10.2 • GENERAL OVERVIEW

§ 10.2.1—Removing Assets From The Taxable Estate

An irrevocable trust is an arrangement whereby the beneficial ownership is separated from the legal ownership. Many irrevocable trusts are designed to remove assets from a client's estate so long as the client does not retain certain rights and powers. The irrevocable trust can be for the benefit of the client's spouse, descendants, or others. The trust can also be designed or administered to have the trust's income taxable to the client, to the trust, or to the beneficiaries.

Important provisions of the trust must be carefully incorporated into the trust document in order to avoid having the trust assets included in the settlor's estate. Specifically, the client must avoid retaining or possessing any powers as described more specifically in the Internal Revenue Code (I.R.C.) under §§ 2036 through 2038, and I.R.C. § 2041. Also, if life insurance is owned by the trust, the client must avoid having any of the powers described in I.R.C. § 2042.

§ 10.2.2—Intentionally Defective

Having the trust income taxable to the settlor allows for further removal of assets from the settlor's estate in that he or she pays income taxes on the trust's income for the benefit of the trust's beneficiaries (*i.e.*, effectively, further gifts). This is discussed in more detail in § 10.4, below.

§ 10.2.3—Gift Tax

The transfer of assets to the trust can be designed as completed gifts. Completed gifts are subject to gift taxes or would utilize the donor's exemption from gift taxes to the extent of the donor's then-available applicable exemption amount. One exception to this involves gifts that are within the annual exclusion amounts (currently $11,000 per donee, or $22,000 per donee if "gift-splitting" with the donor's spouse is elected), provided that the gifts qualify as "present interest" gifts. Generally, to qualify as a present interest gift, the donee must have a current right to benefit from such gift; *i.e.*, an immediate, unrestricted right to the use, possession, or enjoyment of the contributed property (or the income therefrom). This can be accomplished by incorporating into the trust a provision known as a "Crummey provision." Such a provision allows the beneficiaries of the trust a short window of opportunity to withdraw from the trust each contribution. The trust agreement can allow the contributor to designate which beneficiaries have the right to withdraw with respect to any particular contribution. This may be a desirable provision, because it allows the contributor through the trust document to control the funds that are subject to the withdrawal but not, in fact, withdrawn.

§ 10.2.4—Lapsing Crummey Powers

Care must be given to how much a beneficiary may withdraw under the Crummey provisions. If the withdrawal power exceeds the greater of $5,000 or 5 percent of the value of the trust assets (the 5 & 5 Power), and the beneficiary decides to not exercise the power (thereby allowing the power to lapse), then to the extent the power exceeded the 5 & 5 Power, the beneficiary is deemed to have contributed such excess to the trust. This creates potential tax issues for the beneficiary that otherwise typically only apply to grantors of trusts.[3]

§ 10.2.5—Dynasty Provisions

The trust can also be designed to provide benefits to many future generations of descendants of the client. By allocating the transferor's statutory exemption, the trust assets can be contributed in a manner that allows those assets to avoid the generation skipping transfer (GST) tax. If this is accomplished, the GST tax as well as the estate tax is not only avoided for the grandchildren of the client, but can also be avoided for each successive future generation of those grandchildren.

§ 10.2.6—Spendthrift Provisions

Irrevocable trusts also routinely include provisions stating that the beneficiaries cannot pledge, assign or otherwise encumber their interest in the trust and that the creditors of beneficiaries cannot attach, levy against or seek a forced sale of a beneficial interest in a trust. These provisions are designed to avoid allowing a creditor of a beneficiary to attach his or her interest in the trust's assets. The concept of a spendthrift trust in which the creator of the trust is also the beneficiary is discussed at length in § 10.6 of this Chapter.

§ 10.3 • CHARITABLE TRUSTS

Irrevocable trusts include those of the charitable type. The two most popular forms of charitable trusts (also known as split interest trusts) are (1) the charitable remainder trust (CRTs) and (2) the charitable lead trust (CLTs). Either of these two types of trusts can be an annuity trust or a unitrust.

§ 10.3.1—The Annuity Trust Versus The Unitrust

An annuity trust pays a specific dollar amount each year of the trust, regardless of the changes in value of the trust assets. The unitrust, on the other hand, pays out a specific fixed percentage of the value of the trust assets, which are revalued each year. Therefore, even though the fixed percentage remains the same each year, the payout amount changes so long as the value of the trust assets fluctuates.

§ 10.3.2—Features Of The Charitable Remainder Trust

The charitable remainder trust provides for a periodic (but not less than annual) payout amount from the trust to the creator (grantor) of the trust (or some other beneficiary designated in the trust document by the grantor) with the remainder ultimately becoming payable to a charity. The trust must pay at least 5 percent (but not more than 50 percent) of its value each year to the grantor.[4] The remainder of the trust that is distributed to charity must also be at least 10 percent of the initial value of the contributions to the CRT.[5]

In lieu of paying a fixed percentage amount from inception, a charitable remainder unitrust (CRUT) can instead pay a net income amount to the grantor for an initial period and then convert to paying a fixed percentage amount upon the occurrence of specific events (provided certain criteria is met).[6] The CRUT can also "make up" for the shortage of the net income amounts under the fixed percentage amounts once converted to paying a fixed percentage amount (known as a NIMCRUT).

The term of a CRUT can be as long as 20 years (or, alternatively, can be based on the life expectancy of one or more individuals).[7]

The ability to convert taxable gains into tax-free income is often touted as a main attraction of a CRT, whether it is a CRUT or a charitable remainder annuity trust (CRAT). This feature,

however, is misleading in that distributions made from a CRT to the grantor retain their character for income tax purposes. As a result, the CRUT is a deferral mechanism — not a tax avoidance mechanism. Even if the CRT borrows funds in order to make a payout to the grantor, it can be treated as part capital gain as if the CRT had sold trust assets prior to making the payout.[8]

The CRT is also attractive in that the grantor can deduct the fair market value of the remainder interest contributed to the charity as a charitable income tax deduction.[9] Furthermore, with a CRUT, if the annuity amount retained by the grantor is low enough and long enough in duration, the grantor can ultimately receive more than he or she would have if the grantor had sold the assets of the CRUT outright and re-invested the after-tax net proceeds. This is possible due to the income and/or gains from the assets within the CRUT being able to accumulate income tax free.

§ 10.3.3—The Charitable Lead Trust

The charitable lead trust (CLT), as the name implies, is the inverse of a CRT. The CLT pays a fixed percentage amount to a charity for a period of time, with the remainder typically being paid to the grantor's family members.

The CLT allows the grantor to obtain a charitable gift tax deduction.[10] Interest rates impact the amount of this deduction. CLTs are most beneficial at times when interest rates are low. The lower the interest rate, the higher the charitable gift tax deduction (and hence, the lower the taxable gift).

In a charitable lead annuity trust (CLAT), so long as the CLAT assets' rate of return exceeds the discount rate (which is indirectly based on the prevailing interest rates), the excess inures to the benefit of the non-charitable remainderman gift tax free. The charitable lead unitrust (CLUT) is not as favorable in that regard in that the charity shares in the excess rate of return.

Another benefit of a CLT is the reduction of estate taxes if structured properly (this, of course, assumes that the estate tax has not been repealed).[11]

It is important to note, however, that the CLT does not provide the income tax-deferral features of the CRT. It does, however, allow for an income tax charitable deduction if the CLT qualifies as a grantor trust.[12]

§ 10.4 • INTENTIONALLY DEFECTIVE IRREVOCABLE TRUSTS (IDITs)

§ 10.4.1—IDITs In General

An IDIT is an irrevocable trust that is considered a "grantor trust" for income tax purposes pursuant to I.R.C. §§ 671 to 679. It is "defective" only in the sense that it purposely has not been drafted to avoid being categorized as a grantor trust. Since it is a grantor trust, the grantor of the trust will be responsible for paying any income tax on the taxable income generated by the

IDIT's assets. By paying the income tax, the grantor is in effect making additional transfers to the IDITs that are free of the gift tax. This further reduces the grantor's taxable estate. At the same time, this increases the value of the IDIT, because it grows free of any tax burden.

§ 10.4.2—Income Taxation Of A Grantor Trust

Under the grantor trust rules, the grantor typically pays the income tax on the income of the trust. In years past, practitioners often went to great lengths to avoid grantor trust status. However, there are many planning reasons for drafting an irrevocable trust so that it is classified as a grantor trust for income tax purposes. Hence, the term "intentionally defective grantor trust."

One potential disadvantage with an IDIT is that the grantor's marginal income tax rate will likely be higher than the beneficiaries' tax rates. Therefore, in years when substantial trust distributions are made to beneficiaries, a higher combined income tax may be incurred than if the trust and its beneficiaries were taxable under a non-grantor trust arrangement. However, this possible increase in income tax may be outweighed by the estate tax savings that result from the grantor paying the income tax attributable to the IDIT's assets.

The grantor trust classification only determines who pays the income tax on the assets owned by the irrevocable trust. It does not alter any of the estate or gift tax rules.

§ 10.4.3—How An IDIT Reduces The Taxable Estate

An IDIT reduces one's taxable estate in the following manner. The grantor reports the IDIT's income. The grantor pays income tax on such amount, and therefore, the assets in the IDIT grow free of the income tax burden. The grantor's estate is reduced by the amount of income tax paid as well as by the amount of the assets contributed. In essence, the payment of the IDIT's income tax by the grantor can be considered as an additional gift by the grantor to the IDIT, free of any transfer tax implications.

§ 10.4.4—Potential Gift Tax Consequences Of Paying The Trust's Tax

Might there be some gift tax consequences to the grantor paying the trust's taxes? If the income tax paid by the grantor is in substance an additional indirect transfer to the trust or possibly a gift, is it subject to the gift tax? This question will next be analyzed from the position of both the IRS and the practitioner.

Originally, the Internal Revenue Service (IRS) took the position that income tax paid by the grantor on the IDIT's earnings was a taxable gift by the grantor if the IDIT that was otherwise obligated to pay such tax had no requirement to reimburse the grantor for his tax payment.[13] But the IRS did not cite any authority for its position. Further, the trust in the footnoted PLR required the trustees to pay the grantor's income tax. This was important in that the grantor paid an obligation that was otherwise required to be paid by the trustee. As a result, the IRS deemed the payment as a contribution by the grantor to the trust, followed by the trustee's payment of the tax.

Almost all practitioners have taken the opposite view, because there is no voluntary transfer to the trust when, under the I.R.C., a grantor has no choice but to pay the tax under the grantor trust rules. For gift tax purposes, a gift is a voluntary and completed transfer of property by an individual for less than an adequate and full consideration in money or money's worth which is not a bona fide business transaction at arm's length. A tax, even if paid by the donor, is a forced extraction from the government. The discharge of a liability is not a gift.[14]

A change in position appears to have been made by the IRS. PLR 9543049 amended PLR 9444033, eliminating the gift tax issue but not stating why the IRS did so.

§ 10.4.5—Common Methods To Create An Intentionally Defective Grantor Trust

There are two common methods to create an IDIT. The first is to include the power to substitute assets of equivalent value. If the grantor has the power to reacquire trust property by substituting property of equivalent value, the trust will be classified as a grantor trust for tax purposes and all income of the trust will be taxable to the grantor.[15] The second method is to include the power to lend to the grantor without adequate interest or security. If either the grantor or a non-adverse party has a *specific* power to make a loan to the grantor without adequate interest or without adequate security, the grantor will be treated as the owner of the entire trust.[16]

§ 10.4.6—Ability To Toggle Grantor Trust Tax Classification

A planning issue to be addressed is how grantor trust status can be changed to non-grantor trust status, if and when desired. Such a change in status may be desired in the circumstance of the client not having income or assets with which to pay the phantom tax liability.

For example, assume a client created a grantor trust and funded it with $1 million when he was 55 years old. The client lives past his life expectancy and he is now 85 years old. After 30 years, based on an 8 percent return on investment and no distributions, the net worth of the IDIT is now $9.3 million. Assume that the client has now gifted away most of his assets. If, in that year, the income of the trust is 10 percent of its value, or $930,000, the client may well not have the funds to pay the income tax. Certain planning techniques have been employed to terminate the trust's classification as a grantor trust, thus relieving the grantor of any further income tax liability.

One power that could be granted is known as a "specific release power." The aforementioned power of the grantor to substitute property of equivalent value for trust property (which was used to achieve grantor trust status) could be modified by additional language stating: "The grantor may release this power at anytime by providing written notice to the trustees." Another option that may be included is known as a "general release of power." Many times, a trust will have a general provision that allows any person to release a power.

A grantor trust may also have a "toggle switch." What if the grantor renounces a power (so that the trust ends its grantor trust status), but later decides that it would be advantageous if the trust were once again taxable as a grantor trust? Could the trustees, for example, be given a power in the trust document to reinstate a previously renounced power to the grantor, so that the

trust would once again become a grantor trust? That is, would it be advisable or permissible to provide the trustees with such broad powers as to make the grantor trust classification similar to a toggle switch: one minute it is on, the next minute it is off.

Currently, this is a relatively new idea. Some practitioners believe that such broad powers would risk pulling the trust assets back into the grantor's estate, due to (for instance) the grantor's indirect power over trust assets through the collusion or agency of the trustee.

There may be a safer alternative. If the trustees are given the power to change the applicable law of the trust, the planner could consider a design whereby a trust's domestic, non-grantor trust status can be changed to grantor trust status via a change in applicable law to that of a foreign country.

In general, the grantor trust rules were enacted to tax a grantor on the income of a trust where it appeared that the grantor or his spouse had retained certain interests in the assets, or where the grantor or a non-adverse party had too broad of control over beneficial interests in the trust. However, I.R.C. § 679 is an exception to this rule. Under this section, the grantor is treated as the owner of a trust merely because he makes a transfer to a "foreign trust" that has a U.S. beneficiary.

The following three requirements need to be met for a foreign trust to be classified as a grantor trust under I.R.C. § 679: (1) a U.S. person; (2) transfers property to a foreign trust; and (3) there is a U.S. beneficiary.

Therefore, toggling the grantor trust status by the use of changing the applicable law to a foreign jurisdiction is a viable option. As necessary, the trust can be "re-domesticated to the U.S." to once again make it a non-grantor trust.

§ 10.5 • BENEFICIARY CONTROLLED TRUSTS (BCTs)[17]

§ 10.5.1—Overview

If possible, most property owners would want the ability to place their property into a structure whereby they could manage and control it; use the property and income for whatever purpose they desire; have the ability to give the property to whomever they want; and protect the property against lawsuits and taxes.

Many property owners would like to pass their wealth to their children and more remote descendants at such time that they perceive that the donees have attained a sufficient level of responsibility. In addition to shifting control at a sufficient level of responsibility, there generally is the desire to pass the wealth so that the donees can also obtain the beneficial enjoyment virtually equivalent to outright ownership over the property without the exposure to potential creditors. The desire is to avoid the exposures of outright ownership while also avoiding the restrictions and

controls inherent in the traditional trust arrangement. This allows the beneficiary to possess full enjoyment without exposure.

The Beneficiary Controlled Trust (BCT) accomplishes the above-referenced objectives. A BCT can be designed to give a beneficiary control that is essentially equivalent to outright ownership in addition to the insulation of the assets from taxes and creditors, as long as the trust is properly settled and funded by an individual other than the beneficiary.

A BCT can give the beneficiary all of the benefits for life of a gift or inheritance "in trust." Also, the beneficiary can be in almost full control of the trust (including control over the trust's assets and operations approaching outright ownership). A typical BCT continues this structure in perpetuity, giving the control to the senior generation on a per stirpetal basis. This is subject to change by the use of a special power of appointment.

§ 10.5.2—Characteristics Of A Typical BCT

A BCT is most efficiently designed as a discretionary trust. It is a trust arrangement that continues for the child's lifetime and for the successive lifetimes of the child's descendants, generally on a per stirpetal basis with each family branch (the primary beneficiary's family unit) having a separate trust. Also, when specified ages are attained, instead of requiring outright distributions to the child, a BCT puts the child in control of his or her trust. This transfer of control may be deferred if the child's parents (or their designees) believe the child is not currently able to take on the responsibilities of control. This deferment might last until such time that the child(ren) reach the age(s) that outright distributions would have been made had a traditional trust been used.

The trust splits on a per stirpetal basis for each family branch, at which time the primary beneficiary, if he or she has attained the projected age of maturity or upon attaining that age, is in control of his or her separate trust. The use of separate trusts for each branch will avoid conflicts between siblings; permit ease of portability if a primary beneficiary moves to another state; avoid the necessity of trying to match benefits, distributions, or advances; and enable each primary beneficiary to be in control of his family unit's investments. Therefore, each primary beneficiary (and his or her family unit) will benefit from his or her investment experience and will not have to absorb a partial reduction resulting from the poor investment performance of a sibling. In other words, each family unit can be placed in the same position as it would be if the distribution were outright.

§ 10.5.3—Special Powers Of Appointment

A special power of appointment can essentially amount to the ability to rewrite the trust. A broad special power of appointment would give the power holder (usually the primary beneficiary) the right to appoint the property to anyone other than the holder of the power, his or her estate, or the creditors of either, outright or in trust. Alternatively, the BCT's settlor may desire to restrict the class of potential appointees (*e.g.*, to lineal descendants, trusts for their benefit and charities).

A special power of appointment plus a power of amendment given to a third party essentially converts the irrevocable trust into a revocable, amendable, irrevocable trust while preserving the protection from creditors and the IRS. The special power of appointment coupled with a power of amendment results in virtually unlimited flexibility. The special power of appointment enables the primary beneficiary to make adjustments to deal with changing family circumstances as well as changes in the law. The power of appointment also protects the trustee from interference by other beneficiaries. Simply put, the power holder can remove a secondary beneficiary.

§ 10.6 • SPENDTHRIFT TRUSTS

§ 10.6.1—Introduction

A spendthrift trust is a trust created to provide a fund for the maintenance of a beneficiary and at the same time to secure the fund against the beneficiary's improvidence or incapacity. Domestic trust law generally restricts the trust benefits and control that the settlor can retain following trust settlement. This is due to a general rule under American trust law against the enforceability of self-settled spendthrift trusts. Under the law of most states, a trust is "self-settled" if the settlor is a beneficiary and controls the trust or has a general power of appointment over it. A spendthrift trust prevents the beneficiary's creditors from accessing trust assets to satisfy the beneficiary's obligations. While such a trust created for the settlor's benefit is valid, the spendthrift restriction is ineffective as to his or her creditors. The laws of Alaska, Delaware, Nevada, Rhode Island, and Utah (and to a lesser extent, Colorado and Missouri) contain exceptions to the general rule against self-settled spendthrift trusts.

§ 10.6.2—Recent Case Law

In *Scheffel v. Krueger*,[18] the mother of a minor child who was sexually assaulted appealed a lower court's ruling that refused to allow the defendant's beneficial interest in a trust to be attached in order to satisfy a judgment.

The defendant sexually assaulted the plaintiff's child. A lower court held the defendant liable for over $550,000 in damages. The plaintiff sought to attach the defendant's beneficial interest in a trust in order to receive payment. According to the trust, none of the income was subject to the control of the beneficiary's creditors. Additionally, the income was not to be reached by any legal or equitable process in satisfaction of any liability. The trial court held that the spendthrift provision was enforceable against the plaintiff's claim.

The plaintiff argued that the legislature did not intend to shield the trust's assets from tort creditors in a situation where the beneficiary's conduct constituted a criminal act. The court found that the plain meaning of the statute indicates the spendthrift provision is enforceable unless the beneficiary is also the settlor or the assets were fraudulently transferred to the trust. Neither exception applied in this situation. Therefore, the plaintiff's argument failed.

In *Sligh v. First National Bank of Holmes County*,[19] Sligh was involved in an automobile accident with Gene Lorance, an uninsured motorist who was driving under the influence. Sligh suffered a broken spine and paralysis below the waist. Lorance was convicted of driving under the influence and sentenced to 10 years in prison. Lorance's mother had settled two spendthrift trusts with Lorance as a beneficiary. Sligh attempted to garnish both trusts, claiming it was a violation of public policy to enforce and give priority to spendthrift trust provisions over involuntary tort judgments against the beneficiary.[20] Sligh also urged the court to recognize and enforce a public policy exception to the spendthrift trust doctrine in favor of involuntary alienation by tort creditors by subjecting Lorance's beneficial interests to the payment of their tort judgment.[21] The lower court ruled that a tort judgment creditor cannot garnish the trustee of a spendthrift trust in the situation where the defendant is only a lifetime discretionary income beneficiary, nor are the assets of such trust subject to the claims of the tort judgment creditor.[22]

The Mississippi Supreme Court outlined four exceptions stated in the *Restatement (Second) of Trusts* where the interest of the beneficiary can be reached in satisfaction of an enforceable claim against the beneficiary. These exceptions allow for the satisfaction of claims made: (1) by the wife or child of the beneficiary for support or alimony; (2) for necessary services rendered to the beneficiary or necessary supplies furnished to him; (3) for services rendered and materials furnished that preserve or benefit the interest of the beneficiary; and (4) by the United States or a state to satisfy a claim against the beneficiary.[23]

In its decision, the Mississippi Supreme Court went against the grain in holding as a matter of public policy that a beneficiary's interest in spendthrift trust assets is not immune from attachment to satisfy the claims of the beneficiary's intentional or gross negligence tort creditors, and that such claims take priority over any remainder interests in such assets. The court reversed the lower court's decision and allowed Sligh to go after Lorance's interests in both spendthrift trusts.

It should be noted that as a result of *Sligh*, the Mississippi State legislature enacted the Family Trust Preservation Act of 1998. The relevant portion of this Act states: "Except as provided in Section 91-9-509, if the trust instrument provides that the trustee shall pay to or for the benefit of a beneficiary so much of the income or principal or both of a trust as the trustee in the trustee's discretion sees fit to pay, a transferee or creditor of the beneficiary may not compel the trustee to pay any amount from the trust that may be paid only in the exercise of the trustee's discretion."[24] This statute appears to be a direct attempt to contradict the Mississippi Supreme Court's holding in *Sligh*.

§ 10.6.3—Colorado Law

C.R.S. § 38-10-111 is entitled "Trusts for use of grantor void against creditors" and is over 100 years old. Despite this, its application to domestic self-settled trusts is just beginning to be acknowledged. This statute states: "[a]ll deeds of gift, all conveyances, and all transfers or assignments, verbal or written, of goods, chattels, or things in action, or real property, made in trust for the use of the person making the same shall be void against the creditors existing of such person." Note that it is not void for all purposes, but rather solely against the existing creditors of

that person. The term "creditors existing" was interpreted by the Colorado Court of Appeals in *Fulton v. Investment Co. v. Smith*,[25] wherein the court found that as the plaintiff's tort claim arose after the transfer to the trust, the tort claimant must prove that the transfer was made fraudulently (as used in the Colorado fraudulent conveyance statute).

In *Campbell v. Colorado C&I Co*.,[26] the Colorado Supreme Court judicially interpreted "for the use of" and concluded that the statute does not apply unless the principal purpose of the trust is for the use of the grantor. An incidental benefit does not invoke the statute.

The Colorado self-settled trust statute was further interpreted in *In re Baum*.[27] *Baum* centered on two irrevocable trusts settled in 1983 for the benefit of the Baum children. The settlor transferred into the trusts his residence, some furniture and fixtures, and a collection of antique clocks. The settlor reserved the right to live in the residence so long as the settlor "timely services all encumbrances against such residence, and pays all taxes, insurance and utilities on such residence or associated with its occupancy by the Settlor."[28] The settlor also reserved the right to require the trustee to sell the residence and purchase another home as substitute trust property. When the trusts were settled, the settlor had a net worth of over $1 million and had total debts of less than $115,000.

Approximately six years later, the settlor filed for bankruptcy and a bankruptcy trustee was appointed. The bankruptcy trustee subsequently filed an action to recover trust property for the bankruptcy estate asserting: (1) the creation of the trusts constituted transfers for the benefit of the debtor and were thus void as a matter of Colorado law; and (2) that the debtor used trust property as his own, thus effecting a merger of legal and equitable interests in the property. The bankruptcy court referred the case to the district court, which upheld the validity of the trusts. The bankruptcy trustee appealed.

The Tenth Circuit first noted that the bankruptcy trustee's arguments could be categorized that either: (1) "[t]he trusts were void at inception, or at least voidable if necessary for the benefit of creditors, regardless of how they may have been operated; or (2) that the trusts were shams because of the way they were operated."[29]

In addressing the void or voidable argument, the court noted that as a matter of local statutory law, a trust for the use of the person making the same shall be void only as to creditors existing of such person. As the creditors in bankruptcy were not existing as of the date of the settlement, this statute was inapplicable.

As to the second argument advanced by the trustee in bankruptcy, the court noted that while there were apparently no decisions specifically dealing with creation of a sham trust by a debtor, persuasive authority existed "in other contexts, particularly corporate and tax cases, that when a person in a position analogous to debtor here retains too much control over transferred property, ignores legal formalities, and uses the property as his own, the property is treated as owned by the transferor rather than the entity that is the nominal owner."[30] The court concluded that these cases "were all distinguishable from the instant case."[31]

The court disposed of the bankruptcy trustee's claim that the trustee himself failed to properly administer the trusts, particularly noting the settlor's control over the trusts, by noting that "even if the debtor acted as trustee, it does not follow that the trust is a sham."[32] Noting that: (1) "the essence of a valid trust is the separation of the legal and equitable interests in property, with legal title held by the trustee, and the beneficial interest vested in the beneficiaries"; (2) there was no evidence of self-dealing between the trust and the settlor although the settlor may have exercised control over the subject assets and the general administration of the trust; (3) the settlor may have in fact "performed many of the duties of the trustee"; and (4) the trusts were, in fact, administered for the benefit of the Baum children (notwithstanding the continued occupancy of the residential real property by the settlor and his spouse), the court upheld the decision of the lower court and ruled against the trustee in bankruptcy.

§ 10.7 • ASSET PROTECTION TRUSTS

§ 10.7.1—Introduction

Asset protection is a process that includes reorganizing how a client's assets are held so as to make them less vulnerable should a claim be made against the client. Asset protection planning concepts may be applied to protect every type of asset, whether cash, stocks, bonds, business interests, insurance, art, real property, etc. An overall integrated estate plan implements lifetime asset protection planning, which preserves assets during a client's lifetime, with more traditional death-time estate planning goals. The most effective form of an integrated estate plan is the foreign irrevocable trust, which is a trust domiciled in a jurisdiction with protective laws.

§ 10.7.2—The Typical Integrated Estate Plan

A typical integrated estate plan (IEP) combines a foreign integrated estate planning trust (IEPT) with a domestic family limited partnership (FLP). The IEPT's settlor (the individual creating the trust) will appoint one or more trustees and the protector(s). One trustee is often an individual domiciled in the settlor's home jurisdiction (the domestic trustee). The second (or possibly sole) trustee is usually a corporate trustee (the foreign trustee) who is domiciled in the jurisdiction of the IEPT's applicable law. In many jurisdictions, the settlor may serve as the IEPT's protector, which essentially has an oversight authority on the actions conducted by the trustees. An IEPT's protector often has the following "negative" powers: (1) the power to remove and replace trustees; (2) the power to veto investment decisions of the trustees; and (3) the power to veto distribution decisions of the trustees.

An IEPT settled under a foreign jurisdiction's laws can be very protective of assets contributed to it, especially to the extent its assets are placed beyond the jurisdiction of a U.S. court. Should a legal battle arise, a client's creditors will likely be forced to litigate (or even re-litigate) in the foreign jurisdiction and under the foreign jurisdiction's laws. This may create an aversion to proceeding with litigation in that the time involved and the expenses incurred may influence a domestic creditor to abandon hopes of "breaking the trust." Ultimately, however, the real strength

or success of such planning depends on the ability to create an impenetrable brick wall using clear, unambiguous statutes in the controlling foreign jurisdiction.

§ 10.7.3—Advantages Of An Irrevocable IEPT

Four major advantages of a foreign irrevocable trust domiciled in a protective jurisdiction when compared to domestic trusts include: (1) the increased ability of the settlor to retain benefit and control; (2) the foreign trust is less likely to be an automatic target in litigation against the settlor; (3) the foreign element will likely impact a creditor's decision concerning how far to go in pursuing assets; and (4) the foreign element is ultimately more protective.

The presence of the foreign element in a foreign irrevocable trust will likely have an effect on a creditor's decision to either institute suit or pursue assets. The following factors will likely deter a creditor from pursuing assets:

1) **No Comity.** Many foreign jurisdictions' trust laws provide that judgments foreign to that jurisdiction are not to be given force and effect. Therefore, a new trial on the merits under the foreign jurisdiction's law may be required to adjudicate the settlor's liability and the trust's liability for the settlor's separate debt.

2) **Burden of Proof.** The trust laws of many foreign jurisdictions provide that the burden of proof in challenging asset transfers to a trust is always on the party making the allegations, and does not shift to the transferor.

3) **Standard of Proof.** The trust laws of certain foreign jurisdictions provide that the standard of proof to be met by the party making the allegations is the American criminal standard of "beyond a reasonable doubt."

4) **Statute of Limitations.** Trust laws of certain offshore financial centers provide that the statute of limitations for challenging asset transfers to the trust begins to run from the transfer date. Unlike American law, there is no separate statute of limitations that begins to run from the date the transfer is "discovered" by someone with a claim against the transferor. Additionally, a number of foreign jurisdictions have statutes of limitations that are shorter than the typical four-year statute found under American law.

5) **Costs and Fees.** It is expensive to pursue a claim out of state, let alone in a foreign country, particularly when there is no comity (*i.e.*, recognition of foreign judgments or court orders).

6) **Psychological Barriers.** The psychological barriers of dealing with foreign legal systems, the added uncertainty of prevailing under foreign law, the increased time factor, the geographical factor, and the like, serve to substantially enhance the protection of trust assets should a threat against the settlor one day materialize. It is one thing to obtain a judgment, yet quite another to collect upon it.

7) **Foreign Trusts Are Ultimately More Protective.** The trust laws of certain foreign jurisdictions are simply more specific and protective than U.S. state trust law; accordingly, even if a creditor is not dissuaded by the many hurdles erected by a proper foreign-situs trust, protective foreign statutes make it difficult, if not impossible, to pierce a trust in order to satisfy the settlor's separate debts.

One of the primary benefits of a foreign situs irrevocable IEPT includes giving greater effect to favorable spendthrift provisions as to the settlor, and as to others with respect to future potential liability. Ancillary benefits also exist, including: (1) probate avoidance; (2) confidentiality; (3) vehicle for global investing; (4) ease in transferring assets; (5) avoidance of the potential of monetary exchange controls; (6) assistance in the handling of affairs in the event of disability or unavailability; (7) flexibility; and (8) the existence of a "protector," the role of which is better established under the foreign law.

The success of an IEP can be measured by determining whether a client weathers a storm at least moderately better than if he had not engaged in this type of planning. While many variables exist that prevent a blanket statement about the efficacy of IEPTs, it is imperative that the client be made aware that while an IEP may assist in a creditor situation, nothing is absolutely foolproof.

§ 10.8 • CONCLUSION

As shown in this Chapter, irrevocable trusts serve numerous purposes, including depleting one's estate by shifting assets to or for the benefit of lower generation beneficiaries and thereby avoiding estate, gift, and generation-skipping transfer taxes. Charitable goals may also be achieved through the use of irrevocable trusts. These charitable trusts may also include non-charitable goals that benefit the grantor. As also noted in this Chapter, an irrevocable trust provides an excellent tool to protect assets from the creditors of the grantor or of the beneficiary of the trust. An irrevocable trust (or a number of irrevocable trusts) should be considered in devising one's estate plan and in the application of certain tax strategies.

NOTES

1. C.R.S. § 38-10-111.
2. C.R.S. §§ 38-8-101, *et seq.*; *see* 2 Scott, *Trusts*, §§ 156, *et seq.* (3d ed. 1967): *Restatement (Second) Trustees*, § 156 (1959); Annot., 34 A.L.R. 2d 1335, 1342 (1954); Clifton B. Kruse, Jr., "Revocable Trusts: Creditor's Rights After Settlor-Debtor's Death," *Probate & Property*, Vol. 7, n. 6 at p. 40 (Nov./Dec. 1993).
3. I.R.C. § 2041(b)(2) speaks to the lapse of a withdrawal power.
4. I.R.C. § 664(d)(1).
5. I.R.C. § 664(d).

6. *See* Treas. Reg. § 1.664-3(a)(1)(i)(c).
7. I.R.C. § 664(d)(1).
8. *See* I.R.C. § 664(b) and Treas. Reg. § 1.643(a)-8(b)(1).
9. I.R.C. § 170(f)(2)(A) and Treas. Reg. §§ 1.664-4 and 20.2031-7(d) and IRS Publication 1457.
10. I.R.C. § 2522(c)(2)(B).
11. I.R.C. § 2055(e)(2)(B).
12. I.R.C. § 170(f)(2)(B).
13. *See* PLR 9444033.
14. *See*, for example, Treas. Reg. § 25.2511-1(d).
15. I.R.C. § 675(4)(C).
16. I.R.C. § 675(2).
17. The authors wish to give credit to Richard A. Oshins, Esq., of Las Vegas, Nevada, who has lectured frequently on this concept, and has provided the authors with readily available information used toward the content and organization of the discussion of this topic in this Chapter.
18. *Scheffel v. Krueger*, 782 A.2d 410 (N.H. 2001).
19. *Sligh v. First National Bank of Holmes County*, 704 So.2d 1020 (Miss. 1997).
20. *Id.* at 1023.
21. *Id*.
22. *Id*.
23. *Restatement (Second) of Trusts* § 157.
24. Miss. Code Ann. § 91-9-507 (1999).
25. *Fulton v. Investment Co. v. Smith*, 149 P. 444 (Colo. App. 1915).
26. *Campbell v. Colorado C&I Co*., 10 P. 248 (Colo. 1885).
27. *In re Baum*, 22 F.3d 1014 (10th Cir. 1994).
28. *Id.* at 1016.
29. *Id*. at 1017.
30. *Id*. at 1018.
31. *Id*.
32. *Id*.