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Date: 06-Dec-12
From: Steve Leimberg's Asset Protection Planning Newsletter
Subject: **Marty Shenkman & Gideon Rothschild: Self-Settled Trust Planning in the Aftermath of the Rush University Case**

"The Illinois Supreme Court recently held in the Rush University case that a self-settled trust was void as against public policy. Some commentators seized on this holding to reassert that domestic self-settled trusts (DAPTs) are not viable to use. The analysis, however, is much more complex, and the case does not necessarily add great weight to the risk profile of DAPTs.

However, the case is an excellent catalyst to re-examine the discussions about DAPTs, especially in light of the many clients creating completed gift DAPTs in 2012 to take advantage of the current $5.12 million exemption. The discussion below tackles this topic and also endeavors to provide practical insight into the relative risk of many popular irrevocable completed gift trust planning techniques."

We close this week with commentary by **Marty Shenkman** and **Gideon Rothschild** on a recent decision our authors believe will be a catalyst for re-examining Domestic Asset Protection Trusts, especially for clients making gifts to Domestic Asset Protection Trusts to take advantage of the $5.12 million exemption before year-end.

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He is the Recipient of the 1994 Probate and Property Excellence in Writing Award, the Alfred C. Clapp Award presented by the 2007 New Jersey Bar Association and the Institute for Continuing Legal Education; Worth

Magazine's Top 100 Attorneys (2008); CPA Magazine Top 50 IRS Tax Practitioners, CPA Magazine, (April/May 2008). His article "Estate Planning for Clients with Parkinson's," received "Editors Choice Award." In 2008 from Practical Estate Planning Magazine; his "Integrating Religious Considerations into Estate and Real Estate Planning," was awarded the 2008 "The Best Articles Published by the ABA," award; he was named to New Jersey Super Lawyers, (2010-13); his book Estate Planning for People with a Chronic Condition or Disability, was nominated for the 2009 Foreword Magazine Book of the Year Award; he was the 2012 recipient of the AICPA Sidney Kess Award for Excellence in Continuing Education; he was a 2012 recipient of the prestigious Accredited Estate Planners (Distinguished) award from the National Association of Estate Planning Counsels; and he was named Financial Planning Magazine 2012 Pro-Bono Financial Planner of the Year for his efforts on behalf of those living with chronic illness and disability. He sponsors a free website designed to help advisers better serve those living with chronic disease or disability www.chronicillnessplanning.org.

Gideon Rothschild is a partner with the New York City law firm of **Moses & Singer LLP**, where he co-chairs the Trusts & Estates and Wealth Preservation Group. He focuses his practice in the areas of domestic and international estate planning techniques for high net worth clients and is a nationally recognized authority on wealth preservation and foreign trusts.

Mr. Rothschild is the Vice-chair of the Real Property Trust & Estate Law Section of the American Bar Association, a Fellow of the American College of Trust and Estate Counsel and Academician of The International Academy of Trust and Estate Lawyers. He is a member of the Advisory Boards of BNA's *Tax Management* and *Trusts and Estates*, the Immediate Past Chair of the New York Chapter of the Society of Trust and Estate Practitioners (STEP), and a member of the New York State Bar Association. He was an Adjunct Professor at the University of Miami Law School Graduate Program and has lectured frequently to professional groups including the University of Miami's Philip Heckerling Institute, the New York University Federal Tax Institute, the New York State Bar Association, the American Bar Association, and the American Institute of Certified Public Accountants.

Here is their commentary:

EXECUTIVE SUMMARY:

The Illinois Supreme Court recently held in the Rush University case that a self-settled trust was void as against public policy. Some commentators seized

on this holding to reassert that domestic self-settled trusts (DAPTs) are not viable to use. The analysis, however, is much more complex, and the case does not necessarily add great weight to the risk profile of DAPTs. However, the case is an excellent catalyst to re-examine the discussions about DAPTs, especially in light of the many clients creating completed gift DAPTs in 2012 to take advantage of the current $5.12 million exemption. The discussion below tackles this topic and also endeavors to provide practical insight into the relative risk of many popular irrevocable completed gift trust planning techniques.

FACTS:

2012 Trust Planning Overview

There are a myriad of trust options your client may consider for 2012 gifts. While obviously the starting point in selecting the broad type of trust to use (or trusts, as often better results can be achieved with a combination of trusts) your client's financial and other circumstances and personal goals are paramount. Your client's decision process is complicated by having to make decisions in light of the uncertain tax law affecting many of the trust options that are being used. No option is without risks, and even more disconcerting for those trying to make decisions, there are so many variations of each type of trust or plan, that it is impossible to quantify the risk levels, and in many instances, even to rank the options in order of risk. This is why a generic discussion of acronyms (e.g., "DAPTs", "SLATs", etc.) can be so misleading.

Finally, whatever is done at the planning and drafting stage, the proper operation of the trust will be essential to increasing the possibility of a successful tax outcome. Many tax cases hinge on what was done after the documents and plan were created. The many bad-fact FLP cases are certainly a testament to the need for ongoing maintenance of any plan.

With the above caveats, the following discussion will provide a framework for evaluating some of the decisions necessary to the irrevocable trust planning process generally, and in particular, to late 2012 trust planning. Even if your client has already established an irrevocable trust, when the dust settles in 2013 on 2012 planning, your client should still meet with you to evaluate the planning again, and if advisable, modify the trust or ancillary planning based on your more deliberate and less pressured analysis, not to mention possible knowledge of what the new laws may hold.

Self-Settled Trusts Riskier

If your client is a beneficiary of a trust which he or she established, that trust is referred to as a "self settled trust," or a "domestic asset protection

trust" ("DAPT"). If your client's primary goal is to have the assets transferred to that trust removed from his or her estate, as it is for many 2011-2012 transfers in particular (because of the large $5.12 million exemption amount) the gifts to the trust must be characterized as "completed" gifts for gift tax purposes. This type of trust is referred to as a completed gift DAPT or "CGDAPT." The risk inherent in your clients CGDAPT plan will be greater than had your client not been a beneficiary of the trust. However, no one can really quantify the incremental risk that your client's beneficiary status adds to the CGDAPT as compared to other planning techniques. It is also difficult to weigh because there are a myriad of options for how any CGDAPT can be structured, and later administered. Many of these options will be discussed below.

2012 Trust Planning Continuum

Although a simplification of the complex legal and tax issues involved, one approach that can be used to visualize the various trust options, and which will be used as a paradigm for the discussions in this article, is a trust risk continuum. While simplistic for the estate planning specialist, this paradigm might prove useful to illustrating the concepts to both clients and non-estate planning advisers on the clients planning team.

The planning techniques indicated in the upper portion of the continuum are generally less risky than those listed lower down on the trust risk continuum. There are many gradations along the continuum. The top and perhaps less risky, from an estate tax planning perspective, is a trust solely for descendants. The lower options are more risky, e.g. a CGDAPT. But there cannot be any measuring lines demarcating the continuum. This is important for practitioners to emphasize to clients who so often come with preconceived notions of what trusts are appropriate with how much risk they have (typically gleaned for the conversation on the 6th hole). Taxpayers and planners alike would want to quantify the "risk return" payoff from modifying, or even changing, a strategy, but it is simply not possible.

Trust Continuum

↑ Less Risky

***Dynastic trust for descendants for which neither your client nor your client's spouse are beneficiaries.**
***Spousal lifetime access trust (SLAT).**
***Non-reciprocal Spousal lifetime access trust (SLAT) which your client and your client's spouse create for each other.**
***Self-settled trust your client establishes for himself or herself and for**

which he or she is a beneficiary (DAPT).

↓ More Risky

While your client's naming his or her spouse as a beneficiary ("SLAT") of a trust increases the risk of estate inclusion, as compared to a trust solely for heirs (a "dynasty trust"), but both the SLAT and dynasty trust are generally less risky than a trust your client establishes for which he or she is a beneficiary (CGDAPT). If your client establishes a trust for which the client's spouse and descendants are beneficiaries, and the client's spouse in turn establishes a similar but not identical (non-reciprocal) trust, the risk is likely somewhere in between the single SLAT and the DAPT risk levels. As the risk level increases, the potential for the trust assets to be reachable by creditors, and taxed in your client's estate become greater.

So why should your client go through the lengths of establishing a trust and accept increased risks of the trust assets being included in his or her estate? Trusts with increased risk are used to comport with the clients wishes, such as to assure greater financial access to trust assets. The greater the access your client has to trust assets, the greater the risk of those trust assets being included in your client's estate. But that is not the only factor.

A SLAT established in a DAPT jurisdiction with an institutional trustee is likely more secure from an estate planning perspective than a SLAT established in the client's home non-DAPT state with the spouse/beneficiary as a co-trustee, or perhaps the sole trustee. Yet many clients are loath to incur the costs, or deal with the formalities, of a trust formed in another jurisdiction, or of working with an institutional trustee. Clients routinely make decisions that reduce estate planning certainty, but which from their perspective achieve other goals which the client deems more important. The problem with this calculus is that there are no measures to compare the impact on the plan's risk to the other benefits achieved.

In terms of the paradigm of the trust risk continuum, the key personal decision is to what degree your client is comfortable moving up (or down) the trust risk continuum to obtain the incremental degrees of access (or to limit access) to the trust, or to comport with other personal goals that the client is comfortable accepting.

Spousal Lifetime Access Trusts (SLATs)

If your client opted not to be a beneficiary of their trust at all, that would certainly be less risk of estate inclusion. Perhaps the most popular trust of that genre in 2012 is the spousal lifetime access trust or "SLAT." If your client's spouse is a beneficiary, and the SLAT purchased a vacation home your client

would presumably be able to use the house by virtue of his relationship with his spouse.

With a SLAT, if your client perceives the risk of divorce as modest, then perhaps the most significant risk your client faces of not being a beneficiary is the premature death of his or her spouse. Your client could insure that risk if that risk was considered meaningful. That should be "safer" from an estate tax perspective then a CGDAPT. However, if the risk is still uncomfortable, it might be addressed by the clients establishing non-reciprocal SLATs for each other's benefit (and their descendants).

The two SLATs, and the economic results they create, however, have to be sufficiently different to avoid the IRS arguing that the trusts leave your clients each in an economic position that was similar to what they were in before the transfer. If this occurred then the reciprocal trust doctrine could be applied to unwind both trusts. The reciprocal trust doctrine applies where the trusts are interrelated, and that the arrangement, to the extent of mutual value, leaves each spouse in approximately the same economic position as before they created the trusts naming themselves as beneficiaries.

SLATs face other risks as well. If your client makes a gift to a SLAT for his or her spouse, and the trust pays for living expenses that are the grantor/spouse's obligation to provide for under state law, might that undermine the trust? If the grantor/non-beneficiary spouse benefits from the expenses paid by the SLAT, might that evidence an implied agreement with the trustee? Might it evidence a retained right the grantor/spouse had in the trust? What if the SLAT makes distributions to the grantor/spouse that are deposited into a joint checking account from which the grantor/spouse writes checks? How far can the grantor/spouse proceed before the risks of estate inclusion are apparent?

So, while SLATs should have less risk than a CGDAPT, they are far from assured (and there are risks in addition to those noted above). There is a loss of financial security in accepting the SLAT option. So although a SLAT would appear to be appropriately placed higher on the trust risk continuum, signifying less risk, that is not necessarily the case in all circumstances, and certainly not when non-estate tax risks are factored into the analysis.

Since a key difference between the SLAT and the DAPT is the grantor being a beneficiary of the latter, but not of the former, the question is whether the incremental risk is worthwhile. But the reality is that there are a number of variations that can be created between a "pure" SLAT and a "pure" DAPT. Some of these are listed and discussed in more detail below.

Trust Continuum SLAT – DAPT Gradations

↑ Less Risky

***Spousal lifetime access trust (SLAT).**
*** DAPT your client establishes, and your client is domiciled in one of the 13 DAPT states.**
*** DAPT but your client is not a current beneficiary but is part of a class of people that someone in a non-fiduciary capacity can name as beneficiary (so your client might be appointed at a later date). ^**
***DAPT but your client can only become a beneficiary after some 10 Years and one day (after the time period under which a trustee under the Bankruptcy Act can set aside the transfer).**
*** DAPT but your client can only become a beneficiary after some set number of years, and only then if your client is not living together with a spouse as husband and wife (this directly addresses the risk of divorce or your client's spouse dying).**
*** DAPT but your client is not a current beneficiary but is part of a class of people that someone in a non-fiduciary capacity can name as beneficiary (so your client might be appointed at a later date). ^**
***DAPT your client establishes and for which your client is immediately a beneficiary.**

↓ More Risky

^ listed in different locations depending on whose view

The Litmus Test for Estate Inclusion; Creditors

Whether or not creditor protection is a significant concern for the particular client or transaction involved, the ability of creditors to reach trust assets is also the litmus test for determining whether or not trust assets are included in your client's estate for estate tax purposes. For a CGDAPT to be excluded from your client's estate, your client's creditors cannot have had the ability to reach the assets in the trust.

If your client can enable his or her creditors to reach the trust assets, this test will be violated and the assets will be included in his or her estate. So, therefore, your client should not retain the right to alter, amend, revoke or terminate the trust. IRC Sec. 2038(1)(1).

Your client should not hold the right to posses or enjoy, or receive the income from the trust property. IRC Sec. 2036(a)(1). The ability to receive distributions in the discretion of an institutional trustee should not violate this test so long as there is no understanding as to what distributions your client might receive. Your client cannot retain the right to receive the income from the trust. But instead, if the receipt of income is merely at the trustee's

discretion, and there is no understanding between your client and the trustee, this mere "expectancy" should not arise to the level of a right.

Determining whether or not your client's creditors can reach the assets of the trust may depend on which state law is applied to the trust. If your client resides in a DAPT state (e.g., Alaska, Delaware, Nevada, South Dakota) and establishes a CGDAPT in that state, then that state's protective law should apply to make the determination. The more difficult issue is if your client resides in a non-DAPT state (e.g., New York or New Jersey) that does not permit self-settled trusts. If your client establishes a trust in a DAPT state, which state law will govern? If DAPT state law (e.g., Delaware) governs then the assets in the trust, barring other issues, should not be reachable by your client's creditors, and therefore should not be included in his or her estate.

Selected Pre-Rush U Authorities

The following discussion provides a brief overview of selected authorities that precede the recent "Rush U" decisions. Some practitioners have taken the "Chicken Little" view post Rush U, namely: "The sky is falling, the sky is falling." However, the reality is that Rush U is not the first state court case to address the issue of self-settled trusts, and the analysis is far more complex than the Chicken Little perspective.

[i]

In the *German* case the question at issue was whether the decedent held interests in the trust that caused estate tax inclusion. In 1969 the decedent transferred property to an irrevocable trust. The trust permitted the trustees, in their absolute discretion, to pay any or all of the income or principal of the trust to the decedent at any time during her lifetime. The precondition to any such distribution was that the trustee had to first obtain the written consent of the beneficiary who was entitled to receive the principal and accumulated income of the trust after the decedent's death, i.e. the remainder beneficiary.

If the decedent, as a result of this arrangement, was to be considered from an estate tax perspective as if she continued to enjoy the right to the income or principal of the trust until death, the trust assets would be included in her estate. This turned on the application of Maryland law. Specifically, the issue was whether under Maryland law, if the decedent incurred any debts during her lifetime, could her creditors still attach trust assets to collect those debts. The court found that Maryland law did not give decedent's creditors the right to reach trust assets, and, accordingly, her gifts were completed at the time she transferred the assets in trust, and they were no longer subject to estate tax on her death.

In 2009 the Internal Revenue Service ("Service") issued a private letter ruling

which concluded that a trustee's discretionary right to pay income and principal to the grantor, the grantor's spouse and descendants, did not cause the trust assets to be included in the grantor's estate.[ii] But the Service warned that if there was a pre-existing arrangement or understanding between the grantor and trustee that the assets would be included in the grantor's estate. This points to the importance of operating CGDAPTs, and every other trust or estate plan, properly and carefully. This suggests that the operation of the trust would be critical to the determination of estate exclusion.

In 2011 an Alaska court, in Mortensen, held that transfers to an Alaska DAPT were included in the grantor's bankruptcy estate, and hence, reachable by his creditors.[iii] This was a classic "bad facts" case. The grantor was in dire financial straits when he established the trust, had credit card debt, and was struggling with post-divorce financial issues, when he transferred substantially all of his property to the trust. The facts were as opposite as they could be from those of a wealthy taxpayer planning to fund millions of dollars to a completed gift DAPT in 2012 for estate planning purposes.

Mortensen was clearly not an appropriate candidate for a DAPT, the planning was poorly designed and executed, but most significantly, he filed for bankruptcy less than ten years after funding the trust. Under the bankruptcy law, during the 10 year period following transfers to a self-settled trust, the bankruptcy trustee can avoid the transfer. So, the lessons of Mortensen are to be certain that your client is an appropriate candidate for a DAPT, execute the planning with prudence, and if your client runs into trouble don't file bankruptcy if it can be avoided for the 10 year window. In spite of the bad facts (really bad facts) this case has created ripples in the DAPT arena.

The concern Mortensen creates for DAPTs is that, according to some commentators, a transfer to a DAPT is per se fraudulent. If such a transfer were per se fraudulent, creditors could reach the assets in the trust, so that the trust assets would be included in the taxpayer's estate. Not all commentators agree. Others believe a transfer must be consummated with an actual intent to defraud, and that the "per se" concept is too harsh an interpretation. The "per se" theory, they argue, if extended to its natural limits, could conceivably characterize every gift any taxpayer makes which is susceptible to being transferred as a fraudulent transfer, and thus, an incomplete gift.

This is an unreasonable conclusion and one that could enable taxpayers to argue that any gifts the Service seeks to tax are incomplete transfers. Just because a transfer could be deemed to be fraudulent and therefore available to creditors, would suggest no transfer is complete until the statute of limitations on a challenge has tolled. That is not a reasonable interpretation and certainly

has not been followed by the Service.

The extension of the Chicken Little DAPT argument would imply some rather incongruous results. If your client made a gift today of $1 million and it grows to $15 million in four years, the gift would not be deemed completed today, because the statute of limitations has not run on the fraudulent conveyance claim. Instead, the gift could only be deemed completed when the statute of limitations runs on the possibility of a fraudulent conveyance claim, which is four years under many states' laws. Your client would thus have a completed gift of $15 million four years in the future. Thus, the argument that transfers to CGDAPTs cannot be deemed complete because it is voidable against creditors under state law, is certainly not clear.

Some commentators have stated, that based on informal discussions, that the Service has refused to issue rulings on CGDAPTs similar to the 2009 PLR noted above because of the concern that the Mortensen holding means that the litmus test of creditors being able to reach assets would cause estate inclusion. So if the IRS views the risk of a bankruptcy trustee setting aside a transfer to a DAPT (a self-settled trust or similar device, under the Bankruptcy Act's terminology) during the 10 year period, allowing creditors to reach the assets, then transfers to a CGDAPT may be viewed as incomplete gifts for gift tax purposes. This would mean that CGDAPTs that your client intended to be completed gifts would not be removed from the client's estate.

If the Bankruptcy Act 10-year clawback is a concern of the Service, perhaps drafting a DAPT in which your client cannot be a beneficiary for 10 years and one day may solve the problem. While this won't suffice if your client is older, if your client is younger, perhaps in his or her 50s or 60s, a ten year and one day delay in being able to be a beneficiary may not only be tolerable, it may be perfectly consistent with your view that the assets being transferred to the CGDAPT are a nest egg your client should not need, except if there is an unforeseeable change in circumstances.

DAPTS and the Rush University Case

There was a recent case in Illinois that ruled unfavorably on the use of a self-settled trust.[iv] This case may have some repercussions as to how the IRS views these trusts from an estate tax perspective (i.e. is it really excluded from the client/grantor's estate).

As noted above, some experts have stated that the Service will no longer issue rulings on CGDAPTs based on this case.[v] Knowledgeable experts have widely differing views as to the use of DAPTs, and whether or not this case has increased the tax risks associated with this estate planning technique.

As a result of this case, some commentators suggest that you should reconsider how you structure new CGDAPTs. Other commentators suggest that DAPTs should not be used for planning, and instead alternative planning options may be safer and preferable. Whichever perspective you take, for clients that have existing CGDAPTs there may be steps that can be taken to reform the trust, or in operating the trust, that might improve the likelihood of DAPT assets being removed from the client's estate.

General Time Line of Facts

The following simplified time line of the facts in the Rush U case and Robert W. Sessions ("Sessions") activities, will be helpful to understanding the case.

- February 1, 1994 – foreign asset protection trust established and funded with family limited partnership ("FLP") interests.
- Fall 1995 - Sessions made a pledge to a local charity.
- April 19, 2005 - Sessions created a revocable trust and contributed his 1% general partnership interest to the trust.
- April 25, 2005 Sessions died.

Formation of the Trust

On February 1, 1994 Sessions, as grantor, established the Sessions Family Trust in the Cook Islands as a foreign asset protection trust ("FAPT"). The FAPT was irrevocable and included a "spendthrift" provision. The FAPT distribution standards permitted the trustees to make distributions to Sessions of income or principal of the trust for his "maintenance, support, education, comfort and well-being, pleasure, desire and happiness." Sessions himself was named Trust Protector of the FAPT. In this capacity, he retained the power to remove trustees, to veto any discretionary actions of the trustees and the power to appoint or change beneficiaries in his will.

Funding the Trust

Sessions transferred 99% of his FLP and property located in Hinsdale, Illinois, aggregating $19 million, to the FAPT.

The Debt – Charitable Pledge

In the fall of 1995 Sessions made a pledge to a local charity, Rush University Medical Center ("Rush U"), of $1.5 million. The pledge was for the construction of a new president's house on the university's campus in Chicago. In reliance on his pledge the charity built the house and held a public dedication honoring Sessions. Sessions executed several codicils to his will reflecting that any portion of the pledge that was unpaid at his death should be

paid from his estate.

On September 30, 1996 Sessions sent Rush U another letter confirming the charitable pledge he had made. Thereafter, Sessions was diagnosed with cancer and blamed Rush U for its failure to discover the cancer early on. Sessions died on April 25, 2005.

Complaint

On December 15, 2005 Rush U filed an amended complaint against Sessions' estate to enforce the pledge. The third count in the complaint relied on the principle that if the settlor creates a trust for his own benefit it is void as to existing and future creditors and that those creditors can reach his interest in the trust. This common law rule was supported by a number of Illinois cases. [vi]

The court stated the common law rule as follows, noting that it did not require that the transfer be a fraudulent conveyance: "Traditional law is that if a settlor creates a trust for the settlor's own benefit and inserts a spendthrift clause, the clause is void as to the then-existing and future creditors, and creditors can reach the settlor's interest under the trust."

The trustees of the FAPT argued that the common law principal stated above was supplanted by the Fraudulent Transfer Act ("Act") and that the Act provided specific mechanisms to prove that a transfer was fraudulent. The complaint filed by the charity, however, did not allege "that the decedent made a transfer to the trusts 'with actual intent to hinder, delay, or defraud'."

The trustees advocated that the Act superseded common law rights that made a self settled trust fraudulent per se, and hence void. If the Act did supersede the common law, then the charity Rush U, would have to prove that the funding of the trusts was a fraudulent conveyance under the Act.

Appellate Court Holding

The appellate court reversed the lower court and held that the common law cause of action was abrogated by the UFTA. [vii] The appellate court found that if the legislature intended self settled trusts to remain per se fraudulent under the common law, it would not have promulgated a statue defining the conditions required to prove a transfer was fraudulent.

Illinois Supreme Court Holding

There is no clarity in the facts presented in the case whether Sessions had

inadequate assets when he made the charitable pledge. The facts seem to indicate that Sessions may have had appropriate intent to benefit the charity, and only after his cancer was misdiagnosed by Rush U did he opt to endeavor to avoid the pledge. Unfortunately, as noted above, the Illinois Supreme Court had no alternatives to finding Sessions liable because the charity's complaint did not allege a fraudulent conveyance under the Act. So absent finding a common law remedy as the Supreme Court held, the FAPT would have been relieved of any liability.

The Illinois Supreme Court held that common law creditor rights and remedies remained in full force, even after enactment of the UFTA in Illinois, unless expressly repealed by the legislature, or modified by court decision.

Had the case not been appealed, the Appellate Court's holding would have been supportive of the FAPT's position, and the claimant Rush U would have had to prove that the transfers by Sessions were fraudulent conveyances under the Act.

The reasoning of the Supreme Court can be summarized in its quote from a case from 1898 "...it would make it possible for a person free from debt to place his property beyond the reach of creditors, and secure to himself a comfortable support during life, without regard to his subsequent business ventures, contracts or losses." There is certainly no assurance that a court in another state would take a similar view of the law.

Many state courts have held that self-settled trusts are void against creditors. But the Service was apparently not concerned about those cases when they issued PLR 20094402. There is precedent in New York and New Jersey that a self-settled trust is void as against public policy. But there are no cases analyzing the application of this with respect to a DAPT state, like Alaska, Delaware, South Dakota or Nevada. If your client lives in one of the 13 states permitting self-settled trusts, then your client can likely use a CGDAPT. If your client, however, does not reside in one of those states, then there may be an issue. But how much of an issue remains unclear for several reasons.

If the transfer to the self-settled trust was not a fraudulent transfer many commentators do not believe that the trust assets will be reachable. If your client lives in a non-DAPT state, and was subject to a judgment, the client's creditor would take the judgment to the DAPT state where your client had established a CGDAPT.

While the DAPT state may recognize the judgment of the non-DAPT court under the Full Faith and Credit Clause of the Constitution, it appears that the DAPT state law would apply for determining how that judgment would be collected in the DAPT state. Also, when your client establishes a self-settled

trust, the interest the client has retained is merely an expectancy, that of a beneficiary in the discretion of an independent trustee. From a gift tax perspective the interest retained by the grantor cannot be valued actuarially. If the retained interest has no ascertainable value, the value of the gift should be the entire value of the property transferred.

It may also be worthwhile to reconsider what the "right" held by the grantor is? In its most typical form a grantor/beneficiary of a self-settled trust is able to receive distributions in the unfettered judgment of an institutional trustee's discretion.

The term "right" was defined by the Supreme Court in Byrum as follows [viii]:

> *The term "right," certainly when used in a tax statute, must be given its normal and customary meaning. It connotes as ascertainable and legally enforceable power as that involved in O'Malley. Here the right ascribed to Byrum was the power to use his majority position and influence over the corporate directors to "regulate the flow of dividends" to the trust. That "right" was neither ascertainable nor legally enforceable and hence was not a right in any normal sense of that term.*

Arguably, the right of a grantor/beneficiary in the typical CGDAPT is no more ascertainable or enforceable then the right in Byrum. Further, if that right is further circumscribed as suggested below, it becomes even less enforceable.

Is it Reasonable to Use a DAPT in Light of the Risk?

If your wealth is sufficient, establishing a pure dynasty trust of which neither your client nor his or her spouse are beneficiaries is clearly safer than a SLAT or DAPT. If your client's resources are insufficient to give up any access to the assets given, then a SLAT may be preferable to a dynasty trust. If the risk of a single SLAT is financially too worrisome, then perhaps non-reciprocal SLATs may be a more comfortable option. However, if your client does not have a spouse, your client's resources are insufficient, or the risk of divorce or premature death of the client's spouse is too great, your client may be willing, or even insistent upon, accepting the incremental risks of a CGDAPT.

But the above can misstate the risks. A dynasty trust that is planned and or operated in a manner that is so imprudent may face considerable risk of estate inclusion. Being a beneficiary is not the only "string" one can have over a trust. Transferring a business interest to a trust, for example, that the transferor continues to draw unreasonable compensation and perquisites, could be more of a risk then merely being a beneficiary.

This example illustrates several of the fundamental points of much of this planning: it is complex, multi-faceted and needs to be planned, drafted, implemented and operated in a deliberate and careful manner. Much of the confusion comes from the indiscriminant use of names like "SLAT", "CGDAPT" or "dynasty" which obfuscate the myriad of variations that may exist in the document, transfer documents, underlying assets, fiduciaries, quasi fiduciaries, beneficiaries and more.

In spite of the above cases, and others ruling against self-settled trusts, a number of commentators, and it appears many practitioners, have continued to advocate that DAPTs should succeed. The following expresses the views of one, on this issue:

> After approximately 15 years since the first DAPT legislation passed, not a single DAPT has been tested all the way through the court system. Most likely this is because such a large supermajority believes that if tested the DAPT will work to protect its assets from a creditor of the settlor. However, despite the very high likelihood of protection, if there is a way to increase the odds of success even more, then such a strategy should be utilized whenever possible. LISI Asset Protection Planning Newsletter #200 (May 10, 2012).

In the above newsletter, **Steven Oshins** refers to DAPTs as "...one of the most popular asset protection tools in the planner's toolbox..." He also stated that "most people believe that they [DAPTs] work." Bear in mind, however, that these comments are made with respect to self-settled trusts generally, and not specifically the completed gift DAPT which is the focus of many engaging in 2012 estate planning for the $5.12 exemption.

Until there is a case in a non-DAPT jurisdiction where the non-DAPT court holds a DAPT invalid, and the plaintiff pursues an action against the trust in the DAPT jurisdiction and is victorious, the outcome and security of the DAPT technique will remain uncertain and unproven. If the DAPT jurisdiction refuses to respect the non-DAPT judgment (or respects it but does not permit enforcement), then the case will have to be brought to the Supreme Court.

If the Supreme Court upholds the Full Faith and Credit clause of the constitution and the DAPT jurisdiction has to respect the judgment from the non-DAPT jurisdiction, that will confirm that creditors can reach a CGDAPT and that transfers to a CGDAPT will not be a completed gift and will be included in the grantor's estate. However, if the "bad facts" cases like Rush and Mortensen are any indication of the type of trust that might in fact wind its way through the legal system to the ultimate resolution, even that might not be

sufficiently determinative of the issue.

If your DAPT is planned with some, or perhaps several, of the techniques discussed below, it might well differ significantly from Mortensen, Rush U and other future cases. So even a final Supreme Court holding may not fully resolve the issue. All that being said, it appears from the Service's refusal to issue rulings on, the growing weight of cases like Rush U could, regardless of the outcome in the asset protection arena, result in the Service arguing that completed gift DAPT assets, even for properly operated DAPTs, are included in the grantor's estate.

Even commentators who are naysayers about DAPTs appear to acknowledge that in certain instances DAPTs should be successful: "In summary, as to Domestic Asset Protection Trusts: they "work" so long as your assets are kept in a DAPT state and you can stay out of bankruptcy for 10 years. There is an open question as to whether the courts of a non-DAPT state can compel the return of assets from the DAPT state to the non-DAPT state so that those assets are available to creditors..." **LISI** Asset Protection Planning Newsletter #211 (October 10, 2012). So if your client can structure a CGDAPT with assets, such as marketable securities or notes, held in a DAPT jurisdiction, and either avoid bankruptcy or prohibit the grantor's inclusion as a beneficiary for ten years and one day in the trust document, the odds of a completed gift DAPT succeeding will be improved. Suggestions for this type of planning appear below.

Planners should not overlook the added certainty that a Foreign APT offers. Notwithstanding the fact that most all of the U.S. cases dealing with FAPT, to date, have refused to recognize them on public policy grounds, the foreign jurisdictions' laws have successfully prevented the creditors from reaching the trust's assets located offshore. Accordingly, if the litmus test for completed gifts is whether the creditors can reach the assets, a foreign trust (with offshore assets) may be the best self-settled trust approach.

Modifying a DAPT Plan to Minimize Risks

Enhancing the likelihood of any trust, including a CGDAPT, being successful (and understanding that there are no guarantees) should proceed as a four-pronged approach. First the facts and circumstances should be corroborated as being supportive of the success of the plan. Second, the DAPT document should be planned and drafted to lessen the client/grantor's status as a beneficiary to the extent feasible and acceptable. Third, plan to minimize the client's ties to non-DAPT jurisdictions, and maximize ties to the DAPT jurisdiction. Finally, the fourth-prong, the trust should be property administered with an eye to enhancing the likelihood of it being respected.

First-Prong – Circumstances

There are a host of steps preceding the actual funding of the trust that can be taken to potentially enhance the likelihood of success of the DAPT (or other gift and/or irrevocable trust plan). While the circumstances are unique to every transaction, the following might be of some help:

- A "solvency analysis" corroborating that your client is solvent not only before the transfers to the CGDAPT, but after all contemplated transfers. This should demonstrate that your client retained sufficient non-trust assets to maintain your client's lifestyle and pay his or her debts. A budget, financial plan and investment plan demonstrating that remaining assets suffice to provide for your client's needs with a reasonable degree of probability may be one way to corroborate this. For example, if your client's wealth manager can run Monte Carlo simulations demonstrating that with a 80%+ probability over a wide range of market conditions that the retained non-DAPT assets will support your client until perhaps 90%+ of life expectancy, this might be useful. There is no real guidance as to what life expectancy, or what degree of assurance, might be necessary to demonstrate sufficient retained assets. Therefore, this will be a judgment call by your wealth manager.
- The assets transferred to the DAPT should be viewed as a safety net, not as assets your client will need to access for income, cash flow, or principal to live on. Whatever can be done to corroborate this in advance of the transfer will be helpful, but the actual pattern of distributions and use of trust assets after funding is critical to demonstrate the reality of this nest egg approach.
- Endeavor to establish that creation of the trust and transfer of assets to it was not a fraudulent transfer.
- Have lien, judgment and other searches completed, obtain a credit report, or take other similar steps, to help corroborate that there were no known claims when the transfers to the trust were consummated.
- Have the client sign solvency affidavits documenting the state of facts when the transfers are made.
- Confirm all income and other tax filings are current and that there are no audits in process, or if there are that adequate resources are retained outside of the DAPT (and other protective structures) to meet claims.
- Retain local counsel in the DAPT jurisdiction to review the trust document and confirm that it is valid under local law.

Since a challenge might occur years in the future, corroborating the state of facts and intent at the time of the trust being executed, and transfers made thereto, is advisable.

Second-Prong – Planning and Drafting the DAPT to Minimize Your Status as Beneficiary

The more rights and "strings" your client has to the trust as beneficiary, the greater the risk of it being included in his or her estate. The fewer the rights, the lower the risk. So there is a risk continuum your client can move up or down on. But the measures of the movements have no means of being quantified.

- If your client only become a beneficiary of a self settled trust, if and only if, your client is not married (e.g., as a result of the client's spouse's premature death, or divorce) that would be less risk than your client being named as an immediate beneficiary without any such restriction.

- If your client is excluded as a beneficiary for some period of years that may lessen tax risks. If your client declares bankruptcy within ten years of the transfer the bankruptcy trustee can avoid transfers to a "self-settled trust or similar device." Therefore, if your client, as the debtor, is a beneficiary and made the transfer with actual intent to defraud, the transfer can be overturned. [ix]

- If the above approach is used, there may be additional protective benefit of the trust being divided into sub-trusts with your client becoming a beneficiary of only a smaller sub-trust initially, and perhaps additional sub trusts at five year intervals if and only if the first sub-trust of which your client was a beneficiary of was completely exhausted. The argument then would be that only the sub-trust of which your client was a beneficiary would be tainted as a self-settled trust, not all the trust.

- Even though the preference is for a CGDAPT, consider having the trust not naming your client a beneficiary on formation. Instead giving some person the power to appoint a class of beneficiaries that might include the client (e.g., the descendants of the client's grandfather). That is, however, a real economic risk. Who could your client comfortably entrust with that power? If the person holding this power is not a fiduciary then there would be no standard that a court could impose on him or her to appoint your client as a beneficiary. The argument against this approach is the same as giving the trustee the power to distribute to your client as a beneficiary. Your client is still potentially a beneficiary in someone's discretion. It is one step removed, but does it remove the client from the risks? Is it safer that the person authorized to add your client acts in a non-fiduciary capacity?

- The trust agreement could designate a person, such as the trust protector

or independent trustee, as having the authority to remove your client as a discretionary beneficiary. If a claim was to be filed, or your client was on his or her death bed, your client could be immediately removed as a beneficiary arguably truncating self-settled trust status. Incidentally, there are really two aspects to this: (1) the completed gift hurdle (e.g., CGDAPT law will be respected, it's contingent or speculative, you have no creditors when you set up the trust, or statute of limitations has run); or (2) the trust corpus is excluded from your estate. This latter issue can arise independently of the former completed gift issue. For example if there is an "understanding" between your client and the trustee as to distributions. Permitting removal by a third party can eliminate this issue. What about the issue of moving to a DAPT state that does respect and apply these laws. If your client sets up a trust in New York at a time when there are no creditors, and thereafter moves to Nevada, once the statute of limitations on a fraudulent transfer has passed, how could the initial transfer not have been a completed gift?

Third-Prong – Planning to Minimize Your Ties to Non-DAPT Jurisdictions and Maximizing your Ties to the DAPT Jurisdiction

The more connections the trust has to the DAPT jurisdiction, the fewer and weaker the connections the trust has to non-DAPT states, and in particular your client's home jurisdiction, the lower the risk.

- Your client could create a family limited partnership or a limited liability company ("LLC") in the DAPT jurisdictions. This could own the assets given to the DAPT to enhance nexus to the DAPT jurisdiction. In addition, instead of naming your client as the investment adviser (or investment trustee as some refer to the position) to direct the institutional trustee as to which investments to hold, the trust could designate a special purpose LLC to serve in the role of investment adviser and trust protector. Then the people to serve in these roles could serve through their capacities with respect to the LLC so designated (e.g., as managers or perhaps members). Another approach might be to incorporate into the trust document itself direction that the trustee hold the LLC and your client could in turn hold private equity or other real estate investments under the umbrella of that LLC. This could, in addition to adding a connection to the DAPT jurisdiction, eliminate at least one connection to the client's home state jurisdiction serving as investment adviser.

- Don't transfer tangible personal property or real estate to the trust so that courts in the home state (or any non-DAPT state) may obtain jurisdiction (this is referred to as "in-rem" jurisdiction). Transferring interests in a limited liability company ("LLC") that owns real estate results in the transfer of an intangible asset to the trust. However, this

approach does leave the underlying asset in a non-DAPT jurisdiction. If investment real estate or business interests located in a non-DAPT jurisdiction are the client's primary assets, there may be little choice of alternative assets to transfer. This will add to the risk of the DAPT transaction. Another option may be to create SLATs that may minimize the self settled trust risk, but as noted above that approach introduces new risks. This is a jurisdictional issue. The issue discussed in this paragraph should not be confused with the separate issue of the client transferring a residence or other property to a trust and failing to pay rent, thereby causing estate inclusion. So even if you live in a DAPT state you still have to pay rent. There are a plethora of cases holding to this effect. As but one example, decedent's gross estate was held to include the entire value of farmland that the decedent had conveyed to his sons because he retained use and possession of the property without [x] payment of rent.

- If an LP or LLC owns tangible or real property in a non-DAPT jurisdiction the non-DAPT court may endeavor to pierce the entity. If an LLC owns real estate in a non-DAPT jurisdiction, (e.g., New Jersey) and a CGDAPT is formed in, for example, Alaska, the transfer of LLC interests to the DAPT may not prevent a claimant from reaching the real estate. If your client were sued after the transfer, the fact that real estate remains in the client's home state might prove the Achilles heel to the plan. The claimant could file a *lis pendens* (a written notice that a suit has been filed relating to the real property ownership). The result of this is that the real property becomes restricted since any potential lender or potential buyer would be on notice of the issue and unlikely to proceed without consideration of the risk. So while a CGDAPT might provide benefit, that protection could be limited or undermined by the existence of assets with a physical presence in non-DAPT jurisdictions. As noted above, there are sometimes few if any alternatives given the client's goals and asset structure.

- Similar to the potential risks of real or tangible property outside a DAPT jurisdiction is the risk or having fiduciaries outside the DAPT jurisdiction. Naming a trust company in a DAPT jurisdiction is certainly a positive step in most CGDAPTs, and an essential step to endeavor to apply DAPT state law. However, adding a co-trustee in a non-DAPT jurisdiction may expose the trust to that state's court's jurisdiction. Even more dangerous is having a co-trustee in the client's home state. The risk that this could create would be compounded if your client has both a trustee and real property or business interests in his or her home state.

- The issues of naming a non-DAPT state trustee can be compounded if the CGDAPT will hold real estate or business interests. The practical problem for many client transactions is that if a closely held business is the primary or perhaps only asset the client can transfer into the CGDAPT there may be little choice but to fund the CGDAPT with those interests. If closely held business interests are transferred to the CGDAPT the trust will have to be structured as a "directed trust." This might mean that a person, other than the institutional trustee, will be named as investment trustee (investment adviser) and will direct the institutional trustee to hold the business interests as trust assets. For many situations, if your client is the principal of the businesses involved, no one other than the client himself or herself may be willing to accept the liability risk of directing the trust to hold closely held business or real estate assets. While directing the assets to be held in the trust may be viewed as a non-tax sensitive power that itself should not cause estate tax inclusion, the client's serving in a fiduciary capacity in his or her home state, may create the potential for that non-DAPT home state court to assert jurisdiction over the client and perhaps over the trust.

- Some practitioners advise against permitting the client to serve as an investment adviser or investment trustee of their own CGDAPT. The concept is that serving in such capacity may create an incremental tie to the client's non-DAPT state of residence that might jeopardize the ability of the trust to withstand a challenge from a creditor. Other commentators disagree and view the client/grantor serving as an investment trustee as a perfectly reasonable step with no adverse tax implications.

- Another approach, as briefly discussed above, is to establish a single purpose entity ("SPE") in the DAPT jurisdiction and have that entity appointed as the trust investment adviser, trust protector and perhaps other roles. Then the individuals your client would have otherwise named to serve directly in those capacities can hold similar decision making authority in their capacity as manager, member or an employee of the SPE. The theory is that this creates a barrier or distances from your client's home state and from residents of your client's home state directly serving in those capacities.

Trust Continuum: More Gradations

↑ Less Risky

***Dynastic trust for descendants for which neither your client nor his or her spouse are beneficiaries, and which has assets managed by an**

independent trustee.

***Dynastic trust for descendants for which neither your client nor his or her spouse are beneficiaries and which has closely held business assets and the grantor is a key employee and the investment advisor or trustee.**

***Spousal lifetime access trust (SLAT).**

***Non-reciprocal Spousal lifetime access trust (SLAT) your client and your spouse create for each other with significant economic differences.**

***Non-reciprocal Spousal lifetime access trust (SLAT) your client and your spouse create for each other differentiated solely by different limited powers of appointment.**

*** Self-settled trust your client establishes, and your client is domiciled in one of the 13 DAPT states.**

***Self-settled trust your client establishes and for which your client is a beneficiary (CGDAPT), but your client holds no other fiduciary or advisory role, and which does not hold business or real estate entity interests in your home state, but only securities invested by the trustee in the DAPT jurisdiction.**

***Self-settled trust your client establishes and for which your client is a beneficiary (CGDAPT), trust investment adviser and which holds business or real estate entity interests in his or her home state.**

↓ More Risky

Fourth-Prong – Administering the DAPT

Merely establishing the trust properly is not sufficient. The DAPT must be operated properly and in conformity with the DAPT terms, and with consideration to some of the issues that might undermine DAPT planning. Some of these are listed below:

- Never commingle funds. The trust should pay its own expenses, such as accounting fees, directly out of its own bank account. The half-life of clients retaining counsel's recommendations following any office meeting is quite short. Therefore, periodic reviews, and enlisting the entire advisory team to help guide the client, may all help keep the client on the "straight and narrow" path of proper trust administration.

- If the trust is a member in an entity, such as an FLP or LLC, the trustee,

on behalf of the trust, should execute operating agreements and other documents to demonstrate the adherence to appropriate formalities.

- If your client is going to receive a discretionary distribution it should ideally only be made by the institutional trustee, and only after a commercially reasonable distribution request process that gives due regard for other current and remainder beneficiaries. Also, consider confirming that the need for the distribution has occurred because of a change in circumstances from when the trust was first established.

- Report all transfers to the trust on gift tax returns meeting the adequate disclosure rules.

- The trust, and any entities in which it owns an interest, should file all required income tax returns.

Trust Continuum Administration

↑ Less Risky

***Self-settled trust your client establishes and for which your client is a discretionary beneficiary (CGDAPT), but holds no other fiduciary or advisory roles, and which does not hold business or real estate entity interests in your home state. The trust holds solely marketable securities all of which are held in the DAPT state and invested by the institutional trustee. Your client has never received regular distributions from the trust and can only become a trustee if the client's spouse dies.**

***Dynastic trust for descendants for which neither your client nor his or her spouse are beneficiaries and which holds closely held business assets. Your client, as the grantor, is the key employee and the investment advisor or trustee. Your client continues to use the business as a personal pocketbook taking salary and perquisites in whatever manner he or she wishes, and far in excess of what a fair wage would be.**

***Non-reciprocal Spousal lifetime access trust (SLAT) your client and your client's spouse create for each other with no significant economic differences. Distributions from both trusts have been made regularly each year, deposited into a joint bank account, and used to pay core-living expenses that would constitute a discharge of each spouse's legal obligation of support under state law.**

↓ More Risky

Steps to Take Now

If your client has an existing DAPT your client may be able to modify it by creating a new trust with more protective features, such as those discussed above. Your client could then decant the existing trust into the new trust. Another approach may be to file a disclaimer of certain rights or interest that are no longer viewed as optimal, or have a trustee or trust protector utilize some of the flexibility built into the trust document itself to effect modifications.

If your client is planning a new trust, consider incorporating as many of the possible modifications as your client is comfortable with.

COMMENT:

The Rush U case is another straw being added to the camel's back, but the bad facts, and the likelihood that the Cook Islands will ignore any demand on trust assets may make it of less import then some DAPT naysayers suggest. The creditor may levy on the trusts real property interests located in Illinois.

Whatever the outcome of these efforts it does appear that those opting to use self-settled trusts should give careful thought to the use of the trust, and whether steps can be taken to minimize home state, non-DAPT connections, and maximize DAPT state connections. The risks to those considering DAPTs are not new. And even if Rush U has heightened the risks faced by DAPTs, the risks before Rush U could not be quantified, nor can they now.

Thus, if your client has the need, or simply the desire, for access to resources such that a SLAT, or other optional approach is not viable, and your client will accept the risks the technique may afford, your client can proceed with a DAPT post-Rush U for the same reasons your client would have done so prior to Rush U. Hopefully, however, some lessons might be learned to enhance somewhat the likelihood of your plan succeeding.

WE KNOW THIS WILL HELP YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Marty Shenkman

Gideon Rothschild

TECHNICAL EDITOR: DUNCAN OSBORNE

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CITATIONS:

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[i] Estate of Estelle E. German v. The United States, 85-1 USTC ¶13,610, U.S. Claims Court, No. 734-81T, 3/26/85.

[ii] *See* PLR 200944002 and Rothschild, D. Blattmachr, Gans, J. Blattmachr, *IRS Rules Self-Settled Alaska Trust Will Not Be in Grantor's Estate*, 37 Est. Plan (Jan. 2010).

[iii] *Battley v. Mortensen*, Adv. D.Alaska, No. A09-90036-DMD, May 26, 2011

[iv] Rush Univ. Med. Center v. Sessions, ____ N.E. 2d ____, 2012 IL 112906, 2012 WL 4127261 (Ill, Sept. 20, 2012)

[v] Richard W. Nenno, Delaware Trusts 201, Sec. 152, page 291.

[vi] Marriage of Chapman, 297 Ill. App. 3d 611, 620 (1988), and Crane v. Illinois Merchants Trust Co., 238 Ill. App. 257 (1925.

[vii] 740 ILCS 160/1 et seq.

[viii] U. S. Supreme Court in *Byrum*, 72-2 ustc ¶12,859, 408 U.S. 125 (1972). The authors are grateful to Professor Mitchel Gans for this reference.

[ix] The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (P.L. 109-8), Section 548(e) added by Act Sec. 1402(4).

[x] *Baggett Est.*, 62 TCM 333, Dec. 47,519(M), TC Memo. 1991-362.

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