PRACTICAL USES OF DOMESTIC ASSET PROTECTION TRUSTS IN ESTATE PLANNING

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BACKGROUND OF ASSET PROTECTION PLANNING

The parameters of an estate planning practice are constantly expanding. A generation ago, trust and estate lawyers were expected to master probate practice and procedure, and the drafting of wills and probate-avoidance trusts. Now, however, we also must have a working knowledge of a host of other practice areas, including:

- State and federal bankruptcy and debtor/creditor law;
- Elder law (including Medicaid and other public assistance laws);
- Partnership law and taxation;
- Entity selection and corporate income taxation;
- Pension and IRA distribution planning;
- Conflicts and choice of law principles, and the common and statutory laws of other jurisdictions (since situs and forum shopping have become increasingly more important);
- Investment management;
- Corporate finance (including at least a passing familiarity with valuation techniques and strategies that are best understood by business appraisers and financial analysts); and
- Domestic relations law, including marital rights and legal obligations of support.

Estate planners have always concerned themselves with protecting clients' assets from federal transfer taxes. Now, however, clients know that trusts, family partnerships, LLCs, and other structures can protect the family wealth from the risks of living in a litigious society, and often demand that their estate planning encompasses both tax savings and asset protection strategies. Many domestic and offshore jurisdictions have attempted to accommodate this demand by enacting special legislation and creating other incentives to attract private wealth seeking a safe haven.

Estate planning lawyers have responded by using that legislation and business and trust structures to develop strategies that achieve tax avoidance and protect property from spendthrift heirs, hostile spouses, results-oriented judges and juries, plaintiffs' lawyers, and others. For many modern practitioners, "estate planning" and "asset protection" are synonymous.

EVOLUTION OF ASSET PROTECTION TRUSTS (APTs)

Historically, it has been relatively simple to create a trust for a *third-party* beneficiary and protect the trust's assets from the beneficiary's creditors. Until the late 1990s, however, it was difficult or impossible to create and fund a domestic "self-settled" trust that is protected from the *grantor's* creditors. Under the common law, if a person creates an irrevocable trust for his own benefit, but the trust restricts the grantor's ability to voluntarily or involuntarily transfer his beneficial interest, the grantor's creditors can reach the grantor's beneficial interest in the trust, *even if* the grantor cannot force a distribution from the trust to satisfy the claims of the grantor's creditors.[1] This rule, which applies even if the grantor's transfers of property to the trust are not fraudulent, is also part of the Uniform Trust Code (Model UTC). Section 505(a)(2) of the Model UTC provides:

> With respect to an irrevocable trust, a creditor or assignee of the grantor may reach the maximum amount that can be distributed to or for the grantor's benefit. If a trust has more than one grantor, the amount the creditor or assignee of a particular grantor may reach may not exceed the grantor's interest in the portion of the trust attributable to that grantor's contribution.

In the 1990s, an increasing number of affluent US residents spent substantial time, energy, and money creating self-settled trusts in foreign (non-US) jurisdictions that did not follow the common law self-settled trust rule. As a result, a growing number of states have decided that it would be good economic and social policy to encourage US citizens to keep their assets stateside by offering domestic APT alternatives. Alaska and Delaware were the first states to pass legislation (both in 1997) authorizing the use of domestic APTs. Currently, 19 states now allow for the formation of APTs.

USES OF DOMESTIC APTs IN ESTATE PLANNING

APTs are versatile trusts that have a variety of uses in estate planning. Every APT is designed to protect the trust assets from the claims of the grantor's creditors. APTs also can be used to avoid the income tax imposed by the grantor's state of residence, and as a substitute for or companion to a prenuptial agreement. It also may be possible to use an APT to remove assets from the grantor's estate for estate tax purposes.

The rules regarding APTs are governed by the statutes of the various states that allow these trusts, and the rules are not consistent among the states. As a result, asset protection planning is, to some degree, an exercise in forum shopping, and in developing a plan, advisors need to match their clients' objectives with the applicable state law.

Of the 19 APT jurisdictions, all but one of them[2] require that the APT be an irrevocable trust. Irrevocable trusts have long been used to protect the trust assets from the creditors of third-party beneficiaries—that is, the creditors of people other than the grantor. In general, if an irrevocable trust contains a spendthrift clause and authorizes in its discretion, but does not require, the trustee to make distributions to a beneficiary, the beneficiary does not have a property interest in the trust that can be attached by the beneficiary's creditors.

Both the Restatement (Third) of Trusts section 60 and the Model UTC section 504 decouple the rights of a beneficiary's creditors from the beneficiary's power to enforce a trust, regardless of whether the trust is purely discretionary or imposes a standard for distributions. The distinction between a discretionary trust and a support trust is, according to these sources, arbitrary and artificial, and attempting to differentiate them leads to different results, on a case-by-case basis, even where the beneficiaries appear to be similarly situated. [3] However, some states have expressly maintained the distinction between discretionary and support trusts and reject the positions of the Restatement and Model UTC in this regard.[4]

The assets of an irrevocable spendthrift trust of which the grantor is a beneficiary will not be protected from the grantor's creditors unless the trust is created in one of the APT jurisdictions and satisfies that state's criteria for an APT. All of the APT states, except New Hampshire, have specific rules about what will constitute a "qualified disposition" to an APT created in that state. In New Hampshire, any irrevocable trust with a spendthrift clause qualifies as an APT.[5]

Most APT statutes allow the grantor to retain a variety of beneficial interests in the trust. In many APT states, the grantor could, for example: (i) structure a charitable remainder trust, a GRAT, or a QPRT as an APT; (ii) retain the right to receive the trust's income; and (iii) be an eligible beneficiary of discretionary distributions of trust property.

The irrevocable APT will have one of the following four income and gift tax results, depending on the terms of the trust agreement and the jurisdiction in which the APT is formed: (i) complete gift, grantor trust; (ii) complete gift, non-grantor trust; (iii) incomplete gift grantor trust; or (iv) incomplete gift non-grantor trust.

COMPARING THIRD-PARTY IRREVOCABLE TRUSTS TO DOMESTIC APTs

A third-party trust is an irrevocable trust created and funded by a grantor who is not a beneficiary of the trust. A self-settled trust is created and funded in whole or in part by a grantor who is also beneficiary of the trust.

Most inter vivos third-party trusts are created to remove assets from the grantor's estate for estate tax purposes. These trusts, as well as irrevocable trusts created on the grantor's death, such as credit shelter and marital deduction trusts, can be structured to provide reliable asset protection for the beneficiaries. On the other hand, the property of a self-settled irrevocable trust generally is included in the grantor's estate and is not protected from the grantor's creditors, absent a state statute conferring that protection.

Both third-party and self-settled irrevocable trusts can provide their beneficiaries with the right to receive distributions and/or the eligibility to receive them.

Mandatory distribution trusts

The trustee of a mandatory distribution trust is required by the terms of the trust agreement to distribute trust assets to one or more of the trust's beneficiaries. For example, a QTIP trust created for the benefit of the grantor's spouse must require that all of the income be distributed to the spouse at least annually. A mandatory interest also would include a beneficiary's right to receive principal distributions in a single lump sum on a certain date, or to receive distributions in installments over time—for example, the right to receive one-third of the trust's principal when the beneficiary reaches the age of 30, one-half at 35, and the balance at 40.

Discretionary trusts

Mandatory trusts are rigid, and provide the trustee with no opportunity to deviate from the distribution scheme set forth in the trust agreement. For this reason, the current trend in drafting trusts, and in trust legislation, is to provide the trustee with more flexibility in exercising its powers, and to move away from trusts that require distributions of income and/or principal to a beneficiary. This flexibility enables the trustee to administer the trust effectively in light of circumstances that the grantor may not have anticipated when the trust was created. The availability of perpetual trusts, which often are structured to last for many generations of the grantor's family, make such flexibility even more desirable.

In a fully discretionary trust, no beneficiary is entitled to any distributions, and must wait for the trustee to exercise its distribution powers. The trustee may favor the current beneficiary over the remaindermen by distributing principal to the current beneficiary, and may favor the remaindermen over the current beneficiary by accumulating income. The beneficiary has no property interest in the trust, and the beneficiary's interest is a "mere expectancy."

The level of a trustee's discretion can vary depending on whether the grantor has provided any standards or limits on the trustee's discretion over distributions. A trustee's discretion over distributions is sometimes limited by the ascertainable standard of "health, education, support, or maintenance." These words are terms of art in the tax code, and often (but not always) are used to limit the discretion of a trustee/beneficiary in order to avoid adverse transfer tax consequences for the trustee/beneficiary.[6] The standard is said to be "ascertainable" because a court could compel an uncooperative trustee to make a distribution if the beneficiary can demonstrate, for example, that it is necessary to pay the costs of his or her medical care.[7]

At the other end of the spectrum is a discretionary trust that gives the trustee discretion over distributions. When a trustee has simple discretion, it has discretion that is not "sole," "absolute," or "unlimited." Use of those words as modifiers will enlarge the scope of the trustee's discretion. Such enlarged discretion is referred to as "extended discretion." The difference between simple and extended discretion is one of degree, and not of kind. Language conferring extended discretion on a trustee might read as follows:

> The trustee may pay out of the net income or principal, or both, of the trust such amount or amounts (whether equal or unequal, and whether the whole or a lesser amount) as the trustee, in its sole and absolute discretion, determines to or for the benefit of such one (1) or more persons then living as the trustee, in its sole and absolute discretion, may select out of a class composed of the grantor's wife and the grantor's then living issue.

Since the beneficiary of a fully discretionary trust has no right to receive property from the trust, an unhappy beneficiary may challenge, but not compel, a trustee's exercise (or non-exercise) of its discretion. When that happens, the judge must construe the language of the trust agreement and determine the intended scope of the trustee's discretion. When examining a beneficiary's challenge to the discretionary distribution decisions of a trustee of an extended discretion trust, a court will not (or, at least, is not supposed to) substitute its judgment for that of the trustee.

Judicial intervention is not warranted simply because the court would have exercised the discretion differently because judicial interference may undermine the grantor's intent in granting broad discretion to the trustee. However, the court will intervene to prevent the trustee from abusing its discretion or acting in bad faith. Beneficiaries of discretionary trusts can rarely satisfy this burden of proof.

Spendthrift clauses and discretionary trusts

A spendthrift clause in a trust agreement prohibits a beneficiary from transferring his or her trust interest voluntarily or involuntarily. In order for the clause to be effective, it must prohibit both the beneficiary's assignment of his or her interest in the trust and the beneficiary's creditor from collecting directly from the trust. By including a spendthrift clause, a grantor can restrain the transfer of a beneficiary's interest in the income and/or principal of the trust. Unless an exception to the spendthrift rule applies, a beneficiary's creditor cannot attach the beneficiary's protected interest in a third-party trust, and can only attempt to collect from the beneficiary after the beneficiary has received the distribution from the trust.

In states that do not have APT statutes, a spendthrift clause will be invalid to the extent that it applies to the interest of a beneficiary who is also the grantor of the trust.[8] In other words, in non-APT states, a grantor who creates an irrevocable trust for his or her own benefit cannot protect the trust assets from his or her creditors, even if: (i) the trust contains a spendthrift clause; and (ii) in transferring the assets to the trust, the grantor did not intend to defraud his or her creditors. The reason for this is that it is contrary to public policy to allow a person to both enjoy his property and protect it from his or her creditors.

Theoretically, adding a spendthrift clause to a purely discretionary trust doesn't provide any additional protection to the beneficiary, because the transfer is prevented by the very nature of the beneficiary's discretionary interest, rather than (as in a spendthrift trust) by a provision prohibiting alienation. In a purely discretionary trust, the beneficiary's interest is a mere expectancy, not an actual property right, and therefore there is no interest for the beneficiary to transfer or a creditor to attach.[9] However, if the grantor's intent is to provide the maximum level of creditor protection to the beneficiaries, even a fully discretionary trust should contain a spendthrift clause.

On the other hand, a spendthrift provision cannot protect property that the trustee is currently required to distribute.[10] Even if a trust contains a spendthrift provision, the trustee should not be able to avoid creditor claims against a beneficiary by refusing to make a distribution that is required by the express terms of the trust. A creditor can reach a mandatory distribution, including a terminating distribution, if the trustee fails to make the payment within a reasonable time after the designated distribution date.[11] After this reasonable period, payments mandated by the express terms of the trust are in effect being held by the trustee as agent for the beneficiary, and should be treated as part of the beneficiary's personal assets.[12]

The spendthrift protection applies to the trust assets for as long as they stay in the trust (i.e., until they are distributed). Keeping the assets in the trust for as long as possible therefore maximizes the creditor protection the trust provides. Most, but not all, states that have APT statutes have abolished the rule against perpetuities, or modified it to allow for trusts of an extremely long, although not of perpetual, duration (e.g., 365 or 1,000 years).

Trustees

The assets of third-party irrevocable trusts generally are intended to be excluded from the grantor's estate for estate tax purposes. If the grantor retains control over the assets of the trust, however, the trust assets will be includible in the grantor's estate.[13] For this reason, it is very unusual for a grantor to serve as the trustee of an irrevocable third-party trust he or she creates.

For asset protection purposes, appointing a disinterested trustee (i.e., a trustee who is not a beneficiary of the trust) generally is better than having an interested trustee (i.e., a trustee who is also a beneficiary). Although some states have statutes that expressly protect the trust assets from the claims of the creditors of the trustee/beneficiary,[14] allowing a beneficiary to serve as trustee may make it easier for a creditor to argue that the trust assets are available to the beneficiary's creditors, if, for example, the trustee/beneficiary: (i) does not comply with the terms of the trust agreement; (ii) is careless in his or her administration of the trust; or (iii) commingles personal assets with trust assets. However, a spendthrift provision should not be invalid with respect to a beneficiary's interest merely because the beneficiary is also the trustee or a co-trustee.[15]

Most APTs are established for creditor protection purposes, rather than estate tax avoidance, so the need—from an estate tax perspective—to prohibit the *grantor* (who is also a beneficiary) from serving as trustee is not as important as it is with a third-party trust. However, most APT statutes expressly provide that the grantor cannot serve as the trustee, although the grantor may be eligible to serve as a trust protector or investment advisor of the APT.[16]

INTER VIVOS QTIP TRUSTS

An inter vivos QTIP trust allows a client to create and fund a trust during life for the benefit of the client's spouse, without using any of the client's gift tax exemption.[17] The spouse receives all of the net income from the trust during his or her lifetime, and may (but need not) be eligible or entitled to receive principal as well. The QTIP assets can be protected from the spouse's creditors by structuring the trust as a spendthrift trust.[18] The assets also should be protected from the grantor's creditors, because the grantor retains no interest in the trust.

When the spouse dies, all of the QTIP trust property is included in his or her estate,[19] but the trust agreement need not give the beneficiary spouse any control over the disposition of the trust assets upon his or her death. The inclusion of the property in the spouse's estate consumes the spouse's estate tax exemption, which may be preferable to using portability to transfer the unused exemption of the first spouse to the surviving spouse (who is the QTIP grantor). In addition, the beneficiary spouse becomes the transferor of the QTIP property, for GST purposes, upon his or her death.[20] Since the portability rules do not extend to the GST exemption, funding an inter vivos QTIP trust for the less-wealthy spouse provides an opportunity to use that spouse's GST exemption, which, absent the QTIP trust, might go to waste if that spouse dies first.

If the beneficiary spouse dies first, the remaining QTIP trust property can continue to be held in trust for the benefit of the surviving spouse, who was the original grantor of the QTIP trust. When the surviving spouse/grantor dies, the remaining QTIP property will not be included in his or her gross estate for estate tax purposes.

Approximately 10 non-APT states[21] have enacted legislation that protects the QTIP assets from the grantor's creditors after the death of the beneficiary spouse. These statutes provide that after the death of the beneficiary spouse, the remaining QTIP assets are deemed to have been contributed to the trust by the beneficiary spouse, not by the grantor. As a result, the QTIP trust assets would not be considered "self-settled" after the death of the beneficiary spouse, and therefore would not be available to satisfy the claims of the grantor's creditors, even if the state doesn't have a separate APT statute. In other words, the inter vivos QTIP allows the donor spouse to be a discretionary beneficiary of a trust he or she funded, without the requirement of a DAPT structure.

INTENTIONAL NON-GRANTOR TRUSTS

An APT can be structured as a grantor trust or a non-grantor trust for federal income tax purposes. Most APTs are grantor trusts for federal income tax purposes under section 677 of the Internal Revenue Code (Code), because the trustee may distribute income to, or accumulate it for, the grantor of the trust, without the approval of an adverse party. However, in some APT jurisdictions, it's possible for a client to create a *non-grantor* APT for federal income tax purposes, fund the trust with contributions that are not considered taxable gifts for federal gift tax purposes, and still retain the right to receive discretionary distributions of trust income and principal from the trust. This structure can be of great benefit to clients who reside in states with high personal income tax rates, since these clients may be able to create non-grantor APTs, and avoid state fiduciary income taxes on the trust's income in both the APT jurisdiction and the state in which they reside.[22]

Originally known as a "DING" (Delaware Incomplete Non-Grantor Trust), this type of trust structure can be created in any APT state that does not tax income and capital gains accumulated in the trust, and will be referred to in these materials as an "ING."[23] The grantor of the APT must live in a state that does not tax trusts based on the residence of the grantor or beneficiaries (i.e., the grantor's state of residence must not tax the accumulated income or capital gains of an out-of-state, non-grantor trust).[24]

It is important to note that: (i) an ING is not used to avoid federal income tax liability; and (ii) the ING must be created in an APT state, because a trust will be treated as a grantor trust if the grantor's creditors can reach the trust's assets.[25] Under the common law (i.e., the law of non-APT states), creditors can reach the assets of a self-settled irrevocable trust.[26]

Clients usually want transfers to the APT to be incomplete gifts because otherwise the grantor will consume the gift tax exemption when he or she funds the trust, and that used exemption will be wasted if the assets are distributed back to the grantor. Also, the cost of a completed gift might discourage the grantor from transferring to the APT assets having a value greater than his or her remaining gift tax exemption, because the grantor usually does not want to pay gift tax. To make the transfers incomplete gifts, the grantor must retain some power to name new beneficiaries or to change the interests of the beneficiaries, such as inter vivos and testamentary limited powers of appointment. [27]

Even in an APT jurisdiction, it is a challenge to create an incomplete gift non-grantor trust. In order for a trust of which the grantor is a beneficiary to be a non-grantor trust, the consent of an adverse party is necessary with respect to making discretionary distributions to the grantor.[28] Usually the trust will provide for a distribution committee comprised of adverse parties, and that committee will make discretionary distribution decisions.[29] The consent of the adverse parties is required in order for the grantor or the grantor's spouse to receive distributions from the trust or for the trustee to accumulate income in the trust, subject to the grantor's lifetime and/or testamentary limited power(s) of appointment (the grantor's powers of appointment make the transfer to the APT an incomplete gift for federal gift tax purposes).

A series of Private Letter Rulings (PLRs)[30] that analyzed this structure for Delaware APTs concluded that a grantor can create a non-grantor asset protection trust for federal income tax purposes, fund the trust with contributions that are not considered taxable gifts for federal gift tax purposes, and still retain the right to receive discretionary distributions of trust income and principal from the trust. The PLRs also concluded that: (i) a distribution from the APT to a beneficiary other than the grantor would be a completed gift by the grantor; and (ii) the distribution committee members had substantial adverse interests to each other for purposes of Code section 2514, and therefore didn't possess general powers of appointment over the APT. Consequently, distributions from the APT would not be subject to gift tax with respect to the distribution committee members.

In 2007, the IRS issued News Release IR-2007-127, and announced that it was reconsidering the PLRs with respect to the gift tax consequences of the non-grantor, incomplete gift APTs. The IRS indicated that the PLRs may not be consistent with Revenue Rulings 76-503 and 77-158 with respect to the conclusion in each PLR that no member of the distribution committee of the trust holds a general power of appointment.[31] The IRS asked for comments on the subject, and in September 2007, the ABA Section of Real Property, Trust and Estate Law submitted extensive comments concluding that the PLRs are correct, and no member of the distribution committee holds a general power of appointment over the APT. The American College of Trust and Estate Counsel (ACTEC) endorsed the ABA's comments in October 2007.

In 2012, after a five-year hiatus, the IRS again began to issue PLRs on the tax consequences of APTs. Chief Counsel Memorandum 201208026 held that the grantor's retention of a testamentary power of appointment, alone, does not render the grantor's gift to the APT incomplete for gift tax purposes. In 2013 and 2014, the IRS issued several nearly identical PLRs involving a distribution committee similar to the committee in PLR 200502014 (referenced in footnote 30).[32] In the 2013 and 2014 PLRs, the IRS ruled that the grantor's contribution of property to an irrevocable trust for the benefit of the grantor and the grantor's descendants was not a completed gift for gift tax purposes under Treasury Regulation section 25.2511-2, and that distribution decisions by a distribution committee do not result in completed gifts being made by members of the committee (i.e., the distribution committee members do not have general powers of appointment over the APT property). The 2013 and 2014 PLRs essentially provide a roadmap for structuring a non-grantor APT, transfers to which will be incomplete gifts.

Until recently, clients who wished to establish ING trusts often were encouraged to seek IRS approval of the structure of their trusts, because the conclusions of a PLR cannot be relied upon by any taxpayer other than the one to whom it is issued. However, in January 2021, the IRS issued Revenue Procedure 2021-3, which provides a list of areas on which the IRS will not issue PLRs. Two ING-related matters were added to the no-ruling list in 2021, under the section of the Revenue Procedure that describes areas under study in which PLRs won't be issued until the IRS resolves the issue through the publication of a revenue ruling, a revenue procedure, or regulations. Specifically, the IRS will not rule on:

- Whether the beneficiaries who are members of the distribution committee have general powers of appointment; or
- Whether a transfer to a non-grantor trust is an incomplete gift.[33]

Both of these issues are included in the 2022 no-ruling list.[34] In light of this development, until the IRS issues further guidance, practitioners should exercise great caution in advising clients regarding the tax consequences of ING trusts. The tax cost of creating a trust that is intended to be an ING, but turns out to be something else (i.e., a completed gift, grantor trust), could be significant.

ESTATE TAX ISSUES

It is possible to create an APT so that transfers to the trust are completed gifts for federal transfer tax purposes (for example, by not giving the grantor powers of appointment or the power to veto distributions from the trust).[35] However, this result will not necessarily cause the trust to also be excluded from the grantor's estate.[36]

Compelling arguments exist for the proposition that when the state common law self-settled trust rule is reversed by statute, the assets of a statutory self-settled trust satisfying the statute's requirements should not be included in the grantor's gross estate and taxed at death. Since the domestic APT laws prevent creditors from reaching trust assets to satisfy the grantor's debts, it should be possible for the grantor to both make a completed gift and to exclude the trust assets from his estate.

In 2009, the IRS ruled that the transfer of assets by an Alaska resident to an Alaska APT was a completed gift.[37] The IRS concluded that the trustee's discretion to pay income and principal to the grantor, the grantor's spouse, and the grantor's descendants was not, by itself, sufficient to cause inclusion of the trust's assets in the grantor's gross estate, but the IRS warned:

> We are specifically not ruling on whether Trustee's discretion to distribute income and principal of Trust to Grantor combined with other facts (such as, but not limited to, an understanding or pre-existing arrangement between Grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under §2036.[38]

A grantor who creates a domestic APT that is designed to be a completed gift and excluded from the gross estate should report the transfer on a timely gift tax return. Adequate disclosure of the transfer as a taxable gift on the return will start the running of limitations period for assessment of gift tax on the transfer, even if the transfer is ultimately determined to be an incomplete gift. Once the period of assessment for gift tax expires, the transfer will be subject to inclusion in the grantor's gross estate for estate tax purposes only to the extent that a completed gift would be so included.[39]

CONCLUSION

APTs provide unique opportunities for asset protection, income tax reduction, and transfer tax planning. However, these trusts require careful planning to ensure that they are properly structured for the client's specific needs and circumstances.

Notes

1 See Restatement (Second) of Trusts § 156(1).

2 Oklahoma permits the creation of a revocable APT. See 31 O.S. § 13. However, the Oklahoma statute also requires that a majority in value of the assets of the APT consist of "Oklahoma assets" and restricts the identity of the trust beneficiaries. These criteria, plus other requirements that the trust must meet to come within the protection of the Oklahoma statute, would make Oklahoma an undesirable or impossible APT jurisdiction for non-Oklahoma residents.

3 The Restatement (Third) of Trusts section 60 (Transfer or Attachment of Discretionary Interests) and the Model UTC section 504 (Discretionary Trusts; Effect of Standard) eliminate the distinction between discretionary and support trusts, unifying the rules for all trusts fitting within either of those categories. However, the comment to Model UTC section 504 expressly provides: "Eliminating this distinction affects only the rights of creditors…. It does not affect the rights of a beneficiary to compel a distribution. Whether the trustee has a duty in a given situation to make a distribution depends on factors such as the breadth of the discretion granted and whether the terms of the trust include a support or other standard." Model UTC section 506 (Overdue Distribution) provides that regardless of whether a trust contains a spendthrift provision, a creditor can reach mandatory distribution from the trust if the trustee has not made the distribution within a reasonable period of time from the distribution date. For this purpose, the term "mandatory distribution" does not include a distribution subject to the exercise of the trustee's discretion, even if: (i) the discretion is expressed in the form of a standard of distribution; or (ii) the terms of the trust authorizing a distribution couple language of discretion with language of distribution. Lawyers frequently and habitually use "shall" to mean different things, one of which is "may." The comment to section 506 of the Model UTC recognizes this, by concluding that a provision stating that "my trustees shall, in their absolute discretion, distribute such amounts as are necessary for the beneficiary's support," is discretionary, not mandatory. See Millard, Rights of a Trust Beneficiary's Creditors under the Uniform Trust Code*,* 34 ACTEC J. 58, 66 (Fall 2008).

4 See, e.g., S.D. Codified Laws § 55-1-25 (2015).

5 See N.H. RSA 564-B:5-505A(d).

6 A "general power of appointment" is any power that may be exercised in favor of one or more of the following: (i) the powerholder; (ii) the powerholder's estate; (iii) the powerholder's creditors; or (iv) the creditors of the powerholder's estate. I.R.C. § 2041(b)(1)(A) and § 2514. The exercise or lapse of a general power of appointment may result in the trustee/beneficiary making a gift, or having the property that is subject to the power included in the trustee/beneficiary's estate for estate tax purposes.

7 See Model UTC § 504(d) (acknowledging beneficiary's right to maintain a judicial proceeding against a trustee for, inter alia, the trustee's failure to comply with a standard for distribution).

8 See Restatement (Third) of Trusts § 58; Model UTC § 505(a)(2).

9 See Restatement (Second) of Trusts § 155 and comment b (inability of creditor to compel distribution from discretionary trust); cf. Restatement (Third) of Trusts § 60 (reversing the common law rule). Footnote 3 discusses this issue further.

10 See Restatement (Second) of Trusts § 153(2).

11 Model UTC § 506(b).

12 See Model UTC § 506 (comment).

13 See I.R.C. § 2036.

14 See, e.g., N.H. RSA 564-B:5-504(b) and S.D. Cod. Laws § 55-1-28. See also Model UTC § 504(e).

15 Restatement (Third) of Trusts § 58, comment b ("[A] spendthrift provision is not invalid with respect to a beneficiary's interest(s) merely because the beneficiary is also the trustee or a co-trustee."). But see id. § 60, comment g (relating to a discretionary trust of which a beneficiary is the trustee, and stating that creditors can reach "the maximum amount the trustee-beneficiary can properly take…. The beneficiary's rights and authority represent a limited form of ownership equivalence analogous to certain general powers [of revocation or appointment]; thus the rule of this Comment is similarly unaffected by a purported spendthrift restraint").

16 See, e.g., 12 Del. C. § 3570(8)(a) ("qualified trustee" means a person other than the transferor); cf. N.H. RSA 564-B:5-505A(d) (imposing no restriction on grantor serving as trustee).

17 See I.R.C. § 2523. The marital deduction is allowed only to the extent that the gift to the QTIP is reported on the donor spouse's timely-filed gift tax return. See Treas. Reg. § 25.2523(f)-1(b)(4). For an in-depth discussion of inter vivos QTIP trusts, see Franklin and Karibjanian, The Lifetime QTIP Trust–the Perfect (Best) Approach to Using Your Spouse's New Applicable Exclusion Amount and GST Exemption, 44 Est. G. & Tr. J. No. 2 (Mar. 14, 2019).

18 A spendthrift clause will not jeopardize a QTIP trust's eligibility for the estate or gift tax marital deduction. See Treas. Reg. § 20.2056(b)-5(f)(7) and § 25.2523(e)-1(f)(7). However, a spendthrift clause coupled with a forfeiture provision, under which an attempted transfer terminates the beneficial interest, will. See TAM 8248008 (Aug. 18, 1982).

19 I.R.C. § 2044.

20 I.R.C. § 2652(a)(1). However, the donor spouse could make a reverse QTIP election for the inter vivos QTIP trust, which would make the donor spouse (rather than the beneficiary spouse) the transferor of the QTIP trust property for GST purposes upon the death of the beneficiary spouse. See I.R.C. § 2652(a)(3)(B).

21 See, e.g., Florida (Fla. Stat. § 736.0505(3)) and Texas (Tex. Prop. Code Ann. § 112.035(g)).

22 Note that out-of-state clients cannot use a non-grantor APT to avoid state income tax on "source" income from their state of residence. See Lipkind, Shenkman, and Blattmachr, How ING Trusts Can Offset Adverse Effects of Tax

Law: Part I, Tr. & Est. (Sept. 2018). Also note that since 2014, ING trusts may no longer work in New York. See N.Y. Tax Law § 612(b)(41); Montesano, New York Enacts Significant Changes to Its Estate, Gift, GST and Trust Income Tax Laws, Tax. Mgmt. Est., G. & Tr. J. (July 2014).

23 See, e.g., Alaska, Delaware, Nevada, New Hampshire. See also Ghassomian, Eliminate State Tax on Trust Income: A Comprehensive Update on Planning with Incomplete Gift Non-Grantor Trusts, 39 ACTEC J. 317, 322 (Winter 2013); Coleman, State Fiduciary Income Tax Issues, ALI-ABA Course of Study (Representing Estate and Trust Beneficiaries and Fiduciaries) (Jul. 15-16, 2010); and Pulsifer and Flubacher, Eliminate a Trust's State Income Tax, Tr. & Est. 30 (May 2006).

24 There are constitutional limits on a state's ability to tax a trust's undistributed income merely because the trust was created by an income tax resident of the state, or because a beneficiary lives in the state. See N.C. Dep't of Revenue v. Kimberley Rice Kaestner 1992 Family Trust, 139 S. Ct. 2213 (2019) (presence of in-state beneficiaries by itself doesn't empower a state to tax undistributed trust income); Fielding v. Comm'r of Revenue, 916 N.W.2d 323, 328 (Minn. 2018), cert. denied 139 S. Ct. 2273 (2019) (residence of grantor at the time trust was created was not sufficient nexus to tax income that is not sourced to Minnesota).

25 Treas. Reg. § 1.677(a)-1(d).

26 Restatement (Second) of Trusts § 156(1), and Model UTC § 505(a)(2).

27 See Treas. Reg. § 25.2511-2 and I.R.C. § 674(b)(3). Under Code section 25.2511-2(c), a gift is incomplete if and to the extent that the donor reserves the power to name new beneficiaries or to change the interests of the beneficiaries. Under Treasury Regulation section 25.2511-2(b), a gift is incomplete if the donor retains a testamentary power of appointment over the property. Chief Counsel Memorandum 201208026 held that a *testamentary* power of appointment, alone, was not sufficient to make the gift to a trust incomplete, despite the language of Code section 25.2511-2(b). See LISI Estate Planning Newsletter #1936 (March 6, 2012), available at www.leimbergservices.com. Thus, in order to ensure an incomplete gift, the grantor should retain both a lifetime and testamentary limited power of appointment over the trust property. The lifetime and testamentary limited powers of appointment do not cause the APT to be a grantor trust. See Treas. Reg. § 1.674(b)-1(b)(5)(i) (lifetime power of appointment limited by a reasonably definite standard) and Code section 674(b)(3) (testamentary power of appointment). See also Treasury Regulation section 25.2514-1(c)(2) for the rules regarding lifetime powers of appointment that are limited by an ascertainable standard. The donor also could ensure that the gift to the APT is incomplete by retaining, in a non-fiduciary capacity, the right to veto the distribution committee's distribution decisions. The veto power makes the transfer into the trust an incomplete gift under Treasury Regulation section 25.2511-2(c), and a non-grantor trust under Code section 674(a), without subjecting the assets to the grantor's creditors.

28 Code section 677(a)(1) provides that a grantor will be treated as the owner of any portion of a trust if the income may be distributed to the grantor or the grantor's spouse without the approval or consent of an adverse party. Code section 672(a) defines "adverse party."

29 For an in-depth discussion of this issue, see Miller and Behn, Adverse Enough to Be a Nongrantor Trust, Tax Notes Federal (Aug. 12, 2019).

30 See PLR 200715005; PLR 200647001; PLR 200637025; PLR 200612002; and PLR 200502014. PLRs cannot be cited or used as precedent. See Code section 6110(k)(3).

31 If the rationale of the Revenue Rulings were applied to the distribution committee PLRs, distributions from the trust would constitute completed gifts by the distribution committee members. This would produce unprecedented gift tax results. For instance, a distribution from the trust to the grantor would constitute a taxable gift made to the grantor of property which the grantor is already treated for federal transfer tax purposes as owning. Furthermore, a distribution to any other person besides the grantor would constitute a taxable gift of the same property to the same person at the same time by both the grantor and the distribution committee members. M. Gordon, Use of Delaware Incomplete Gift Non-Grantor Trusts in Light of IR 2007-127 (2008).

32 See, e.g., PLR 20131002 (Nov. 7, 2012) and PLR 201426014 (June 27, 2014). For more recent rulings, see also PLR 201925005 through 201908008 and 201908003 through 201908007.

33 See Rev. Proc. 2021-3, Section 5 (.01)(15) and (17).

34 See Rev. Proc. 2022-3, Section 5 (.01)(15) and (18).

35 See Rev. Rul. 76-103, 1976-1 C.B. 293.

36 See PLR 9837007 (June 10, 1998) (transfer to Alaska APT was a completed gift, but IRS refused to rule on whether trust property was includible in grantor's estate).

37 See PLR 200944002 (Jul. 15, 2009).

38 See Rothschild, Blattmachr, Gans and Blattmachr, IRS Rules Self-Settled Alaska Trust Will Not Be in Grantor's Estate, 37 Est. Pl. 3 (Jan. 2010).

39 Treas. Reg. § 301.6501(c)-1(f)(5) (adequate disclosure of incomplete transfers). The impact of the IRS gift tax disclosure regulations is that even adequate disclosure of an incomplete gift will not bind the IRS, by reason of the ostensible expiration of the statute of limitations period, to deem a gift to be incomplete. Although even the adequate disclosure of an incomplete gift to an APT can provide no possible benefit from a tax reporting perspective under the IRS regulations, adequate disclosure is still important from an asset protection perspective, because it is important to ensure that all possible indicia of a transfer to the APT are firmly established to help defend against potential creditor arguments that the court should deem the grantor as the real "owner" of the transferred property under a variety of possible arguments. In addition, with respect to some assets (e.g., uninsured artwork), it is possible the grantor's gift tax return may be the only outside evidence of the transfer which ever exists.