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THE ONSHORE TRUST: IT'S ALSO AN ESTATE PLANNING TOOL

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INTRODUCTION

Offshore asset protection trusts are used generally by wealthy persons to protect assets from creditors by placing such assets outside of federal and state jurisdictions, such as on an offshore island in the Caribbean or the South Seas. [1] Now, "offshore"-type protection can be found "onshore" through the use of an onshore trust, technically known as a self-settled spendthrift trust.[2]

The paper will begin by briefly explaining what an onshore trust is and how it came into being. Onshore trusts will then be compared to offshore trusts. Further, the paper will provide a discussion about gift and estate tax considerations in light of these self-settled spendthrift trusts. In conclusion, it will offer some planning suggestions to increase a settlor's chances of receiving favorable estate tax effects.

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[1] Jesse Dukeminier & Stanley M. Johanson, Wills, Trusts, and Estates, 639 (Aspen Publishers, Inc. 6th ed. 2000).

[2] *Id*. *See also, infra* note 14.

WHAT IS AN *ON*SHORE TRUST?

To comprehend what an onshore trust is we must understand the meaning of its more technical synonymy, self-settled spendthrift trust. First, a *trust* is a tool, whereby one entity (settlor) transfers its property to another entity (trustee), directing the trustee to hold the property for the benefit of another entity (beneficiary).[3] Next, a *spendthrift* trust protects trust assets from a beneficiary's creditors and in certain situations (where the trust is irrevocable), might even protect trust assets against future creditors of the settlor.[4] Today, spendthrift trusts have been accepted in almost every state,[5] even though negative

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[3] Dukeminier, *see supra* note 1 at 553 to 562. An "entity" can be a person, or any other legal entity recognized by the state (*i.e.*, William Streng and Bank of America Corporation). Multiple entities may fill each of the three roles. Also, one entity may fill up to two of the roles. If one entity fills all three roles, however, a trust does not exist. *See id*.

[4] *Id*. at 631. The spendthrift trust is the ideological descendent of the English fee tail. *See id*. A spendthrift trust is a trust "in which by the terms thereof a valid restraint on the voluntary and involuntary transfer of the interest of the beneficiary is imposed. It is an active trust not governed or executed by any use or rule of law of uses." *See* Nev. Rev. Stat. § 166.020 (Supp. 2003).

[5] *Id*. at 632. The two court decisions mainly responsible for allowing spendthrift trusts are *Nichols v. Eaton*, 91 U.S. 716 (1875), and *Broadway National Bank v. Adams*, 133 Mass. 170 (1882). *See id*.

repercussions to society are arguably material in nature.[6] And finally, the term *self-settled*, implies that the trust is set up by the settlor for the settlor's own benefit.[7] In sum, the *self-settled spendthrift trust* is a tool whereby an entity might protect its assets from attack by potential future creditors while concurrently maintaining some measure of control over and while continuing to receive some benefit from such assets.[8]

In 2003 the state of Utah[9] joined Nevada,[10] Alaska,[11] Delaware,[12] and Rhode Island[13] in legislatively creating a self-settled spendthrift trust.[14] Although five states have

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[6] *Id*. *See, e.g.*, John C. Gray, Restraints on the Alienation of Property 262 (1883) ("The general introduction of spendthrift trusts would form a privileged class, who could indulge in every speculation, practice every fraud, and provided they kept on the safe side of the criminal law, could yet roll in wealth"); and Adam Hirsch, Spendthrift Trusts and Public Policy: Economic and Cognitive Perspectives, 73 Wash. U. L.Q. 1 (1995) (arguing that spendthrift trusts don't create serious problems for contract creditors)).

[7] *Id*. at 639. Generally, a spendthrift trust cannot be set up where these conditions exist. *Id*.

[8] *See*, Jeffrey L. Burr & Mark Lee Dodds, Nevada's New Asset Protection Act, 8-APR Nev.Law. 19 (2000) (discussing asset protection using the new Nevada self-settled spendthrift trust).

[9] U.C.A. 1953 § 25-6-14 (2003).

[10] Nev. Rev. Stat. § 166.040 (Supp. 2003).

[11] Alaska Stat. § 34.40.110 (West 2003).

[12] Del. Code Ann. Tit. 12 § 3571 (Supp. 2003).

[13] R.I. Gen. Laws § 18-9.2-2 (2003).

statutorily enacted the use of self-settled spendthrift trusts,[15] this paper will draw on Nevada's version as an example.[16] In Nevada, for a spendthrift trust to be considered self-settled, it must have as one of its trustees either: (a) a natural person who resides and has his domicile in Nevada; (b) a legally organized trust company that maintains an office in Nevada; or (c) a legally organized bank that maintains an office in Nevada, and possesses and exercises trust powers.[17] Furthermore, the trust must *not*: (1) be revocable; (2) intended to hinder, delay or defraud known creditors; and (3) require a distribution to

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[14] Alaska's self-settled spendthrift trust was established in 1997 with Delaware enacting its version shortly thereafter. Nevada created its version of the trust in 1999 along with Rhode Island in that same year. *See supra* notes 1-4.

[15] Saying there are five states may be slightly misleading, because both Missouri and Colorado arguably have enacted self-settled spendthrift trust laws (Mo. Rev. Stat. § 456.080.3 (2003), and Colo. Rev. State. § 38-10-111 (2003)); however, practitioners in both of these states don't promote the statutes, and decisions by federal courts in Missouri (*In re* Markmueller, 51 F.3d 775 (8th Cir. 1995)), and the Colorado Supreme Court (*In re* Cohen, 8 P.3d 429 (Colo. 1999)) have called the statutes effectiveness into question. *See*, Richard W. Nenno, Planning with Domestic Asset Protection Trusts, SJ036 ALI-ABA 421, 442 (2003).

[16] This paper will focus on Nevada's version, mainly because the student author plans to practice law in Nevada upon completion of law school.

[17] Nev. Rev. Stat. § 166.015(2) (Supp. 2003). Legally organized refers to being "organized under federal law or under the laws of [Nevada] or another state." *See id*.

the settlor of corpus or interest (the settlor may receive it only in the discretion of another person).[18]

While onshore trust provisions present many interesting questions regarding asset protection from creditors,[19] this paper directs its attention towards the estate planning and wealth preservation implications of employing such a trust. More specifically, it will discuss transfer tax applicability.

WHY *ON*SHORE INSTEAD OF *OFF*SHORE?

Domestic asset protection trusts have several advantages over offshore trusts.[20] First, onshore trusts will more likely be recognized by courts than will trusts located far away, on foreign soil.[21] Second, trusts created under the laws of jurisdictions within the United

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[18] Nev. Rev. Stat. § 166.040 (Supp. 2003). Utah has pending legislation to enact another requirement, that if "the transfer is made when the settlor is insolvent or the transfer renders the settlor insolvent," it won't meet the requirements for onshore treatment. *See* 2004 UT S.B. 47 (SN) at 22-6-14 (2)(c)(vi).

[19] *See supra* note 6.

[20] Thomas O. Wells, Domestic Asset Protection Trusts—A Viable Estate and Wealth Preservation Alternative, 77-MAY Fla. B.J. 44, 49 (presenting four ways in which onshore trusts are more advantageous than offshore trusts).

[21] *Id*. *See also*, *In re* Lawrence, 238 B.R. 498, 500 (challenging the purpose of creating an offshore trust, the court said, "it defies reason…to accept and believe that this [d]ebtor transferred…over 90% of his liquid net worth, to a trust in a far away place administered by a stranger").

States might be much stronger than and more secure than those created under foreign law.[22] Third, onshore trusts avoid the special tax reporting rules of offshore trusts.[23] Lastly, the use of an onshore trust avoids adverse federal income tax consequences that may be associated with the ownership of offshore trust assets.[24]

ESTATE PLANNING CONSIDERATIONS

Self-settled spendthrift trusts, in addition to protecting assets,[25] may provide substantial transfer tax benefits thought the strategic use of gift, estate and generation-

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[22] *See supra* note 19.

[23] *Id*.

[24] *Id*. ("Under I.R.C. § 684, ownership of assets by a foreign trust can result in a deemed sale, with gain taxable in an amount equal to the difference between the fair market value of the assets owned by the foreign trust over the adjusted basis of such assets in the hands of the transferor").

[25] According to Mr. Nenno, "no legal challenge to a domestic asset protection trust has been brought to date. Early in 2003, a rumor circulated that an Alaska asset protection trust had been breached. In fact, the case in question involved a transfer that probably was fraudulent, by an Alaska resident to a foreign (Nevis) asset protection trust that was to be administered in Alaska." Nenno *supra* note 15 at 465 *citing*, David G. Shaftel, Allvest--Validity of Domestic Self-Settled Discretionary Spendthrift Trusts, Steve Leimberg's Asset Protection Planning Newsletter #29 (April 23, 2003), at http:// www.leimbergservices.com.

skipping transfer (GST) tax planning.[26] This section will in turn discuss how each of the three transfer taxes relates to the use of onshore trusts. Then it will provide planning suggestions for setting up and administering the onshore trust to improve chances of favorable IRS treatment, and in the event of future litigation to receive validating court approval.

Gift tax. One reason people choose to gift their property to onshore trusts, is to exclude the post-gift appreciation of trust assets from the settlor's gross estate, while retaining a discretionary right to receive distributions from the trust.[27] A completed gift is made by parting with control and dominion over the property put into the trust.[28] To part with control and dominion, the settlor cannot take actions which enable creditors to reach trusts assets.[29] Also, if the settlor retains a special testamentary power of appointment over assets in an onshore trust, the gift to such trust will not be considered

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[26] For discussions of estate planning in the context of the self-settled spendthrift trust, *see* Nenno, *supra* note 15 at 461; Karen E. Boxx, Gray's Ghost—A Conversation about the Onshore Trust, 85 Iowa L. Rev. 1195 at 1241 (2000); and Wells, *supra* note 19 at 48.

[27] *See supra* note 19.

[28] Treas. Reg. § 25.2511-2(b).

[29] *See* Nenno, *supra* note 15 at 463. *See, e.g.*, *Vander Weele v. Commissioner*, 27 T.C. 340 (1956), *aff'd*, 254 F.2d 895 (6th Cir. 1958); *Estate of Paxton v. Commissioner*, 86 T.C. 785 (1986); *Outwin v. Commissioner*, 76 T.C. 153 (1981); *Paolozzi v. Commissioner*, 23 T.C. 182 (1954); *Estate of German v. United States*, 7 Cl. Ct. 641, 85-1 (1985); Rev. Rul. 77-378, 1977-2 C.B. 347; and Rev. Rul. 76-103, 1976-1 C.B. 293. *Id*.

complete for gift tax purposes.[30] Making sure that assets are completely gifted to the trust is essential in order to keep any future appreciation from being included in the settlor's estate at the time of death.[31]

Estate tax. The assets of a trust will be included in the settlor's gross estate for federal income tax purposes if, at his death, the settlor has a power to alter, amend, revoke, or terminate the trust.[32] The settlor must also relinquish enough control over the trust assets, so that creditors are not able to reach such assets.[33] Further, the settlor must not have "possession or enjoyment of, or the right to the income from the property" if the settlor desires exclusion of trust assets from his gross estate.[34] However, as intended by those who enacted self-settled spendthrift trust legislation, the settlor may receive distributions, but only upon the exercise of complete discretion by the trustee.[35] This

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[30] *See* Nenno, *supra* note 15 at 461. *See also*, Treas. Reg. § 25.2511-2(b). The main issue here is whether the settlor has enabled creditor's to get trust assets by retaining too much power. *Id*.

[31] *See supra* note 19. As implied earlier, onshore trusts are generally used by the very wealthy. Appreciation on such wealth can be substantial. *See supra* note 1.

[32] I.R.C. § 2038(a)(1).

[33] *See supra* notes 27 and 28. *See also*, I.R.C. § 2036(a)(2).

[34] I.R.C. § 2036(a)(1).

[35] Priv. Ltr. Rul. 80-37-116 (June 23, 1980) (ruling that the assets of an offshore trust, in which the trustee had discretion to distribute principal and in income to the settlor and other family members who were beneficiaries, was not includible in settlor's gross estate). Priv. Ltr. Rul. 93-32-006 (Aug. 20, 1992) (ruling that "under the facts presented,

means that the trustee has the discretionary power *but not* the obligation to make distributions to the settlor.[36] Such obligation can take the form of an express or implied understanding to distribute assets.[37]

GST tax. The settlor's allocation of the GST exemption to transfers to a domestic asset protection trust will not be effective as long as the assets of the trust are includable in the settlor's gross estate.[38] "Consequently, the [settlor] might want to fund a trust to which GST exemption is to be allocated with assets that [he] will not need and in which [he] reserves no interest. [The settlor] might then place the balance of the assets to be protected in a domestic asset protection trust that is not structured to be a completed gift or excludable from the gross estate."[39]

CONCLUSION: PLANNING SUGGESTIONS

In determining potential taxes, one of the most important questions to answer is whether the trustee's power to distribute trust assets to the settlor is discretionary or obligatory.[40] Courts have used four ways to examine whether an implied understanding

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the [t]rustee's discretion to make distributions to the [s]ettlor is not a retained interest or power for purposes of [§§ 2036, 2037, or 2038]). *See* Boxx, *supra* note 24 at 1250. *See, e.g.*, Nev. Rev. Stat. § 166.040 (Supp. 2003).

[36] Treas. Reg. § 20.2036-1(a). *See also*, *infra* notes 40 to 43.

[37] *Id*.

[38] Treas. Reg. § 26.2632-1(c).

[39] *See* Nenno, *supra* note 15 at 465.

[40] *See infra* notes 40 to 43.

existed between the settlor and the trustee that trust assets would be distributed to the settlor.[41] First, they may look at how much of the settlor's property is placed in the trust in relation to how much the settlor retains.[42] Second, courts might examine the pattern of distributions to the settlor, more specifically the extent and regularity to which such distributions occur.[43] Third, they might analyze the relationship between the settlor and trustee.[44] Finally, courts will look at evidence that implies a settlor's continued reliance on support from the trust.[45]

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[41] *See* Boxx, *supra* note 24 at 1246.

[42] *Id*. *See also*, *Estate of Green v. Commissioner*, 64 T.C. 1049 (1975). The taxpayer transferred the bulk of her assets to an irrevocable trust and the court held the trust assets to be includable in her gross estate. *See id*.

[43] *See* Boxx, *supra* note 24 at 1246. *See also*, *Estate of Paxton v. Commissioner*, 86 T.C. 785 (1986) (holding that the settlor transferred almost all of his assets into the trust and it was unlikely that he would have left himself or his wife destitute, he did not file a gift tax return, and his son, with whom he shared a close relationship, was trustee over the trust).

[44] *See* Boxx, *supra* note 24 at 1246. In the case of *McCabe*, circumstances indicated an understanding existed that the trustee, a long-time friend of the settlor, would invade principal for the settlor's benefit when needs arose at retirement. *See Estate of McCabe v. United States*, 475 F.2d 1142 (Ct. Cl. 1973).

[45] *See* Boxx, *supra* note 24 at 1246. *See also*, *Estate of Skinner v. United States,* 316 F.2d 517 (3d Cir. 1963) (finding a prearrangement to distribute trust assets, because settlor received all the trust income and settlor's gift tax return, filed when trust was set up, showed a deduction for the value of her life estate).

Thus, to improve the integrity of an onshore trust, the settlor might: (1) withhold a sufficient amount of property from the trust to take care of probable future needs; (2) file a gift tax return upon transfer of assets to the trust, not showing a deduction for the life estate; (3) avoid the appointment of "close" family members and friends to be trustees; (4) receive distributions from the trust in irregular patterns, both with respect to timing and amount; and (5) also distribute trust assets to beneficiaries other than the settler.[46]

In conclusion, the favorable estate planning advantages presented through the use of onshore trusts are potentially great, yet not guaranteed.[47] Courts will look at the facts of each individual case and determine if control over the assets and the obligation to receive income and res from the trust have truly been given up by the settlor in both form and substance.[48]

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[46] *See supra* notes 30 to 43.

[47] *See* Richard W. Nenno, Planning with Domestic Asset Protection Trusts, SH069 ALI-ABA 1963, 2000 (2003) ("Although a [settlor] is likely to get more certain tax results if he or she cuts all ties with specific assets, the [settlor] might not be willing to use certain tax benefits without retaining some potential ties to those assets").

[48] *Final note*: Because people want to "have their cake and eat it too," (*see id*.) it is possible, if not probable, that onshore trusts will continue to grow in popularity (i.e., the state of Utah just jumped on board). As this occurs, estate planning practitioners throughout the country may need to advise their clients about this option to avoid malpractice liability. *See* Nenno, *supra* note 15.