

Aug 1, 2003 12:00 PM

## Alaska Adopts a New Trust Law

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On July 10, Alaska Governor Frank Murkowski signed into law a new state trust bill that passed the 23rd Alaska legislature by unanimous vote.<sup>1</sup> The provisions of this bill improve creditor protection for third-party beneficiary trusts and self-settled trusts, further enhancing Alaska's desirability as a place to create and maintain trusts. The most dramatic change for third-party beneficiary trusts is the ability of a third-party beneficiary to serve as sole trustee and still be protected from creditor claims. Now, for the first time, a domestic self-settled trust law limits the class of creditors that can be considered "pre-existing creditors" with the right to an unlimited statute of limitations during which to bring a fraudulent conveyance action against a settlor. But there is a lot more to Alaska's new laws.

### DYNASTY TRUSTS

Changes in the law for dynasty trusts are, in order of importance:

- **COURTS CANNOT COMPEL DISTRIBUTIONS OR ATTACH BENEFICIAL INTEREST**

One of the principle reasons for creating a dynasty trust is to provide creditor protection for third-party beneficiaries. Creditor protection is dependent on the protection given by a spendthrift clause and the law of the state where the trust administration occurs.<sup>2</sup> Alaska's spendthrift clause provides extremely powerful protection because it bars all creditors from attaching trust assets before payment or delivery of the assets to the beneficiary. This protection includes claims brought against a beneficiary by spouses for support, ex-spouses for alimony, providers of necessities, tort creditors and claims for child support.<sup>3</sup> This protection continues as long as the assets remain in trust and ends when the trust assets are paid or delivered to the beneficiary.<sup>4</sup>

Previously, practitioners were concerned that an Alaska judge might circumvent this protection by ordering the trustee to make a distribution to the beneficiary, which then could be attached by a creditor. That worry was put to rest by a provision in the new

state law stating that an attachment or other order may not be made against the trustee with respect to a beneficiary's interest held in trust.<sup>5</sup>

- **BENEFICIARY CONTROL WITH NO LOSS IN PROTECTION**

In many circumstances, a settlor would like to give a beneficiary as much control as possible, provided there is no loss in creditor protection. Toward this end, many settlors want the beneficiary to serve as the sole trustee. The trend in the law, however, is to treat a beneficiary serving as the sole trustee as having a limited form of ownership.<sup>6</sup> The *Restatement of the Law Third, Trusts* provides that when a beneficiary is appointed as the sole trustee, a claimant can reach the maximum amount that the beneficiary could distribute to himself.<sup>7</sup> The bill, in marked contrast to the Restatement, provides a spendthrift provision will be valid, even though the beneficiary is appointed the sole trustee.<sup>8</sup>

If a beneficiary is appointed the sole trustee, the beneficiary's authority to make a trust distribution to himself must be limited to an ascertainable standard that relates to the beneficiary's health, education, maintenance or support, to avoid having the assets included in the beneficiary's taxable estate.<sup>9</sup> This restriction might place an unwanted ceiling on the level of distributions that can be made to the beneficiary. To get around it, the trust instrument could provide that the beneficiary, serving as a co-trustee, would have the authority to make distributions to himself that are limited to an ascertainable standard, while an Alaskan trustee, independent of the beneficiary within the meaning of Internal Revenue Code Section 672(c), would have the authority to make distributions to the beneficiary unrelated to this standard.

If the beneficiaries are not residents of Alaska, there should be a direct expression of intent that the administration of the trust occur in Alaska, and that there always be one trustee who is a "qualified person" as defined in Alaska Statutes 13.36.390(2).<sup>10</sup> Before the new Alaska law, creditor protection for non-residents could be achieved only by appointing an independent trustee with discretionary authority to make trust distributions. It is now possible to name a non-resident beneficiary as a co-trustee with distribution authority without compromising creditor protection.

- **MERE POSSESSION OF A GENERAL POWER OF APPOINTMENT DOES NOT EXPOSE THE ASSETS TO CREDITOR CLAIMS**

In every large estate, it is possible that distributions will be made to subtrusts — which may or may not be exempt from generation-skipping transfer taxes. Because the estate tax is progressive, federal taxes payable at death often will be less if the assets in a non-exempt trust are exposed to estate tax at the beneficiary's death (rather than having the assets exposed to generation-skipping transfer tax). To accomplish this, a beneficiary in a non-exempt trust can be given a testamentary general power of appointment that will result in the trust assets being included in the beneficiary's estate tax base.

One of the most important provisions of Alaska's new law states that a beneficiary can have a general power of appointment and the assets subject to this power can not be

attached by the beneficiary's creditors.<sup>11</sup> This protection exists regardless of whether the power of appointment is testamentary or presently exercisable.

The position of the *Restatement of the Law, Property Second* as it relates to both an unexercised testamentary general power of appointment and an unexercised but presently exercisable general power of appointment, is that the appointive assets cannot be subjected to the claims of a beneficiary's creditors, unless provided by statute.<sup>12</sup> The theory is that until the donee exercises the power, he has not accepted enough control over the appointive assets to confer the equivalent of ownership.<sup>13</sup> If a beneficiary exercises a testamentary or a presently exercisable general power of appointment, the appointive assets can be reached by creditors.<sup>14</sup> Nonetheless, mere possession of a power of appointment, potentially exercisable in favor of a donee's creditors, is considered a general power of appointment under Treasury Regulations Section 20.2041-1(c).

This provision is also important in any trust that has given a beneficiary a Crummey withdrawal right. The *Restatement of the Law Third, Trusts* considers a beneficiary with a Crummey right to be the owner of the property over which the rights could be exercised, thus exposing the trust to creditors' claims.<sup>15</sup> In Alaska, a beneficiary can have a Crummey withdrawal right and the trust assets can be protected from creditors' claims.

- **USE PROVISIONS RESPECTED**

A use provision allows a trustee to make trust assets available to the beneficiary. The new Alaska law states that property may be made available for the use of a beneficiary without being considered a distribution, thus insulating the trust assets from the claims of a beneficiary's creditors.<sup>16</sup>

- **TRUST PROTECTORS AND TRUST ADVISORS ARE NOT CONSIDERED FIDUCIARIES**

No doubt better creditor protection can be achieved where an independent trustee is given the discretionary authority to make distributions. A frequent objection to this arrangement is the corresponding lack of control that a beneficiary will have over the trust assets. To minimize this concern, settlors often give a trust protector the power to remove and replace the trustee. In the absence of state law to the contrary, however, a court could consider the trust protector a fiduciary, thus decreasing the possibility of finding someone willing to take on the trust protector role. The new Alaska law states that a trust protector will not be held accountable as a fiduciary.<sup>17</sup>

Additionally, a settlor might appoint a trust advisor who is personally knowledgeable about the beneficiary's circumstances to assist a corporate trustee. The appointment of an advisor greatly improves the chances of fulfilling the settlor's purpose. The new Alaska law states that an advisor will not be held accountable as a fiduciary.

## **SELF-SETTLED TRUSTS**

Many of the protections applicable to third-party beneficiary trusts also apply to self-settled trusts. But the new law contains some very important changes that apply exclusively to self-settled trusts. In order of importance, they are:

- **CORRECTION OF MAJOR DEFECT IN SELF-SETTLED LEGISLATION**

The new Alaska law remedies a substantial defect contained in all other domestic self-settled trust legislation: the lack of a definition for a “pre-existing creditor.” In all domestic self-settled jurisdictions, a “pre-existing creditor” has the benefit of what is essentially an unlimited statute of limitations to set aside a transfer of assets as a fraudulent conveyance.<sup>18</sup> A pre-existing creditor has an undefined period of time to make a fraud claim because the creditor might not reasonably discover the transfer of assets to a trust until many years afterwards.

Consider this example: A doctor, unaware of any patient complaints, transfers property to a self-settled trust. Subsequent to the transfer, a patient who was seen prior to the transfer alleges he was negligently misdiagnosed. Should this patient be considered a “pre-existing creditor” even though the patient’s claim was unknown to the doctor at the time the doctor transferred assets to the trust? If so, the patient would be allowed an unlimited period of time in which to assert a claim that the settlor’s transfer in trust was fraudulent and to have the transfer in trust set aside. As a result, no doctor, no contractor or, for that matter, no individual who has ever been engaged in business for any length of time, could ever completely discount the possibility of a “pre-existing creditor” successfully attacking the trust.

The new Alaska law defines a “pre-existing creditor” as one who either:

- demonstrates, by a preponderance of the evidence, that he asserted a specific claim against the settlor before the settlor transferred assets to the trust; or
- within four years after the settlor transferred assets to the trust, files an action in court against the settlor asserting a specific cause of action based on an act or omission (for instance, a negligent surgery) that occurred before the transfer.

- **TIGHTENING THE DEFINITION OF A FRAUDULENT CONVEYANC**

Before the new Alaska law was enacted, a transfer to a self-settled trust could be set aside if the creditor proved a transfer in trust was “intended in whole or in part, to hinder, delay, or defraud.”<sup>20</sup> Unfortunately, that open language gave creditors a huge arsenal with which to attack a trust.

By its very nature, a self-settled trust is meant “to hinder or delay” a creditor. The term “hinder or delay” is contained in Section 4 of the Uniform Fraudulent Transfer Act that has been adopted by Delaware, Nevada, Rhode Island and Utah.<sup>21</sup> The problem created by the phrase “hinder or delay” surfaced in the recent Wyoming case of *Breitenstine v. Breitenstine*.<sup>22</sup> In that case, the state Supreme Court said: “Our case law indicates that an ‘intent to hinder or delay creditors’ is enough to consider the conveyance fraudulent even if there was no actual fraud.”

Alaska has solved this problem by deleting the two phrases “in whole or in part” and “hinder or delay” from its statute. A settlor's transfer of property in trust can now be set aside only if a creditor can prove the transfer was made with an “intent to defraud that creditor.”

- **NEW AFFIDAVIT REQUIREMENT**

It is common practice for an attorney to require an affidavit from a settlor of a self-settled trust stating the conveyance is not fraudulent as to any creditor. Alaska now requires the settlor to sign a sworn affidavit containing specific provisions before the settlor transfers assets to the trust.<sup>23</sup> As a result, the chance of a fraudulent conveyance has been reduced; the affidavit also provides additional protection to the attorney who drafts the trust.

- **PROTECTION OF CRTS, INCLUDING UNITRUSTS WITH NON-CHARITABLE REMAINDER BENEFICIARIES**

Various other provisions in the new Alaska law duplicate provisions of Delaware's Qualified Dispositions in Trust Act. The most important of these allow a settlor to protect an annuity or unitrust interest that has been retained in a charitable remainder trust.<sup>24</sup> In addition, a settlor may create a self-settled trust and protect the retention of a unitrust interest, provided the unitrust amount does not exceed the maximum that may be stated as income under Alaska's newly amended Principal and Income Act or under IRC Section 643(b).<sup>25</sup>

- **PRESERVATION OF A DISTINCTION IN ALASKA LAW**

What remains unchanged is a very important distinction contained in Alaska law that is not found in the self-settled trust legislation of Delaware and Utah. In Alaska, no creditor of the settlor (not a child support agency, a spouse, nor an ex-spouse) is able to reach any of the trust assets.<sup>26</sup> Completed gift treatment is dependent upon a determination that no creditor is able to satisfy its claim out of the trust assets. Herein lies the ability of a settlor in an Alaskan self-settled trust to make a completed gift that is not theoretically possible in Delaware or Utah. In each of those other states, specified creditors who come into existence after the trust is established can have their claims satisfied out of the trust.<sup>27</sup> Because a transfer of assets in a self-settled trust in those states must be viewed as an incomplete gift, the trust assets are still part of, and thus must be included in, the settlor's gross estate.<sup>28</sup>

Admittedly, Alaska requires that a settlor cannot be delinquent in a child support obligation when the trust is settled. The status of these obligations, however, can be determined easily when the trust is settled. As the new Alaska law made its way through the legislative process, the Child Support Enforcement Division wanted a child-support exception for claims that arose after the trust was settled. Ultimately the legislature agreed that the ability of a settlor to make a completed gift was an important attribute to maintain, and that spendthrift protection should be effective against all creditors who arise subsequent to the establishment of the trust.

# STAY TUNED

Preserving wealth during life and moving it forward in a manner that can benefit future generations should be the goal of every estate planner. As reflected by the new trust law, Alaska is in the vanguard of a growing list of states that has embraced these dual objectives. The question remains: What will Alaska do next?

## Endnotes

1. The bill may be found at <http://www.legis.state.ak.us/pdf/23/Bills/HB0212B.PDF>.
2. *Restatement Second*, Conflict of Laws Section 273.
3. The spendthrift statute applies equally to third-party beneficiary trusts and self-settled trusts, see AS 34.40.110 (a), (h).
4. *Ibid.*
5. AS 34.40.110(c)
6. *Restatement Third*, Trusts Section 60, cmt g.
7. *Ibid.*
8. AS 34.40.110(h)
9. Treas. Reg. 20-2041-1(c)
10. AS 13.36.035(c)
11. AS 34.40.115. Rhode Island has a similar statute, see R.I. Gen. Laws Section 34-22-13
12. *Restatement, Property Second*, Donative Transfers Section 13.2 (1986)
13. *Ibid.*
14. *Ibid.* Sections 13.4, 13.5, see AS 34.40.115
15. *Restatement Third*, Trusts Section 58, cmt. f(1), ex. 11. The concept of ownership in the *Restatement Third*, Trusts, is in contrast to the *Restatement Second Property: Donative Transfers* Section 13.2 (1986).
16. AS 34.40.110(a)
17. AS 13.36.370
18. See Del. Code Ann. title 12 Section 3572 (b)(1); NRS Section 166.170; Rhode Island Gen Laws Section 18-9.2-4 (b); Utah Code Ann. Section 25-6-14 (4)(a)
19. AS 34.40.110(d)
20. AS 34.40.110(b)
21. Del. Code Ann. title 6 Section 1304(a)(1); NRS 112.180(1)(a); Rhode Island Gen. Laws Section 6-16-4 (a)(1); Utah Code Ann. Section 25-6-14(2)(c)(i).
22. 2003 WY 16, 62 P.3d 587, paragraph 18 (Wyo. Jan. 30, 2003)
23. AS 34.40.110(k), which has prospective application only.
24. AS 34.40.110(b)
25. AS 34.40.110(b)
26. See PLR 9837007, Treas. Reg. 25.2511-2; Rev. Rul. 76-103, 1976-1 C.B. 293; *Paolozzi v. Commissioner*, 23 T.C. 182 (1954); *Commissioner v. Vander Weele*, 254 F.2d 895 (6th Cir. 1958); *Estate of German v. United States*, 7 Cl. Ct. 641 (1985)
27. Del. Code Ann. title 12 § 3573 (2) allows trust assets to be attached to satisfy a claim for child support or alimony. Utah Code Ann. Section 25-6-14(2)(c)(vii) allows trust assets to be attached in satisfaction of a claim or tax of the state or its political subdivisions.
28. An argument has been advanced by Richard W. Nenno and W. Donald Sparks, II, in Schurig and Osborne, *Asset Protection: Domestic and International Law and Tactics* (West Group, 1995), Section 14A:126 which claims the statutorily authorized exceptions in Delaware law are “acts of independent significance” which do not produce an adverse

transfer tax result.

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