

## **Alaska Trust Company's Gift & Estate Tax Analysis of Alaska Self-Settled Spendthrift Trusts**

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It seems relatively certain that an Alaska Irrevocable Trust should not be included in the estate of the grantor who is merely eligible, but not entitled to, receive distributions from the trust unless (1) creditors of the grantor can attach the trust assets under the laws where the trust is located, or (2) the IRS shows there was an understanding with the trustee that property would be returned to the grantor. Here is our analysis:

The best starting point, we think, is Herzog v. Commissioner, 116 F.2d 591 (2d Cir. 1941), which was decided by one of America's great judicial panels (Judge Learned Hand, Judge Augustus Hand, and Judge Chase). The case stands, in our view, for the proposition that if property transferred to a so-called "self-settled" trust (i.e., one from which the trustee, other than the grantor, may, but is not required, to make distributions to the grantor) and is not subject under the law governing the trust to claims of the grantor's creditors, the transfer is complete in its entirety for Federal gift tax purposes.

The next development to consider, we think, is Rev. Rul 54-538, 1954-2 CB 316 (modified by Rev. Rul. 62-13, 1962-1 CB 180, clarified by Rev. Rul. 77-378, 1977-2 CB 347). In Rev. Rul 54-538, the Service ruled that where the interest (which interest appears to have been the possibility that the trustee could distribute trust assets to the grantor) retained by the grantor is not capable of valuation, the interest retained cannot be subtracted from the value of property transferred as a gift to the trust—i.e., the whole value transferred to the trust is subject to gift tax. However, as noted, Rev. Rul. 62-13 modified Rev. Rul. 54-538 and held that where the power of invasion of the trust for the grantor is so great that there is no assurance that anything of value will ever be paid to a beneficiary other than the grantor, no part of the transfer to the trust is a completed gift.

The Federal Court of Appeals for the Seventh Circuit held in Uhl v. United States, 241 F. 2d 867 (7<sup>th</sup> Cir. 1957), in substance, that property in a self-settled trust is includible in the grantor's estate only to the extent that under local law the grantor's creditors could attach the trust assets. The Seventh Circuit determined that under Indiana law, at that time, the grantor's creditors could not invade the trust and that therefore the trust corpus (over and above that necessary to produce the \$100 per month that the trustee was directed to pay the grantor) was not includible in grantor's estate under old Revenue Act section 811, the precursor of current section 2036.

The general rule in the United States is that creditors can attach the assets in a self-settled trust. Restatement Trusts (Second) section 156.2. However, in many

states, the law is undeveloped on this point. The two states with the most notable statutory exceptions to the Restatement are (1) Alaska which provides that if certain requirements are met that creditors may not attach assets in self-settled trusts (AS 34.40.110) and (2) Delaware which offers protection from some, but not all, creditors for qualified dispositions to self-settled trusts (12 Del. Code Ann. § 3570 et seq.). (Missouri has a statute somewhat similar to the ones in Alaska and Delaware.)

The next significant development, we believe, was the issuance of Rev. Rul. 76-103, 1976-1 CB 293. In that ruling, a taxpayer created a self-settled trust in a state where the grantor's creditors could, as under Restatement Trusts (Second) sec. 156.2, attach the trust assets. The Service ruled the ability of the creditors to reach trust property rendered the transfer to it incomplete for Federal gift tax purposes. However, the ruling stated that

[i]f and when the grantor's dominion and control ceases, such as by the trustee's decision to move the situs of the trust to a state where the grantor's creditors cannot reach the trust assets, then the gift is complete for Federal gift tax purposes under the rules set forth in section 25.2511-2 of the regulations.

This ruling seems to be based on, and cites to, Paolozzi v. Commissioner, 23 TC 182 (1954), acq. 1962-1 CB 4.

Rev. Rul. 77-378, cited above, dealt with a self-settled trust again in a state where the grantor's creditors could not reach the trust assets. The ruling states, in part, that

[w]hether [the grantor] would enjoy any of [the trust's] income depended entirely on the trustee, who, in his uncontrolled discretion, could deprive him of it completely. \*\*\* Such a hope or passive expectancy is not a right. \*\*\* Rev. Rul. 62-13 is hereby clarified to remove any implication that an entirely voluntary power held by a trustee to distribute all of the trust's assets to the grantor is sufficient to render a gift incomplete either in whole or in part.

You may wish to note that the "hope or passive expectancy is not a right" statement is taken from the Board of Tax Appeals decision (41 BTA 509 (1940) at 510) in the Herzog case.

The only way the assets in a self-settled trust are includible is if the grantor retains an interest described in Code Sec. 2036, 2037, or 2038 (or 2042 with respect to life insurance proceeds). Each of these sections speaks in terms of retaining a "right," and that is exactly what Rev. Rul. 77-378 says was not retained ("...is not a right.") Rev. Rul. 77-378 clarified Rev. Rul. 62-13 to remove any implication that an entirely voluntary power held by a trustee to distribute all of the

trust assets to the grantor is sufficient to render a gift to the trust incomplete even in part. And, of course, we know that estate and gift tax provisions are supposed to be construed similarly (or as courts say "in pari materia"). As a general rule, if there is no right at all retained for Federal gift tax purposes, there should be none for Federal estate tax purposes.

There are additional other cases and private letter rulings completely supporting the foregoing. The official Tax Court syllabus in Wells v. Commissioner, TC Memo 1981-574, states:

Decedent transferred property to a trust which provided that the trustee may, in his sole discretion, distribute to decedent corpus and/or income. Held, although decedent received the income from the trust, she did not receive it pursuant to an agreement, express or implied, entered into contemporaneously with the transfer of the property to the trust and therefore she did not retain "possession or enjoyment" of the property within the meaning of sec. 2036(a)(1).

Another especially instructive case is Estate of German v. United States, 7 C1. Ct. 641 (1985). Mrs. German, who was not a resident of Maryland either when she created the trust, or when she died, created the trust under Maryland law (where one but not all trustees resided). Under the trust, the trustee could distribute property to her. The IRS contended that the trust was included in her estate under Code Sec. 2036. The court held that this turned on

whether she continued to enjoy the right to the income or principal of the trust up to the date of her death, because under Maryland law if she chose to incur any debts, her creditors could still attach or levy upon the trust assets to collect them.

Because the IRS did "not establish that under Maryland law creditors of the settlor could have reached the trust income or principal of her discretionary trust up to the time of her death" the Court denied the government's motion for summary judgment on estate tax inclusion. The fact that the trustee needed the consent of an adverse party to distribute property to her is of no moment. It does not even seem that this really affected the Court's interpretation of Maryland law. But even if it did, the basic Federal estate tax proposition stands: If creditors of the grantor cannot attach the asset of the trust under the law governing it, the trust is not includible in the grantor's estate. No other reading of the case is reasonable. By the way, you might find it instructive to read the government's briefs in German. We believe you will find them completely consistent with everything we have recited above about the state of the law.

There are also several private letter rulings (not official precedent) which also are exactly consistent with the foregoing. For example, in PLR 8037116, the

taxpayer created a self-settled trust and the question came up as to whether it was includible in his estate. The national office stated, in part

the decedent did not retain the right to possess, enjoy, or receive income from the property, but he did retain the opportunity to enjoy it. However, in the same jurisdiction, the Circuit Court of Appeals has characterized such a beneficiary status as a hope or passive expectancy rather than a right to enjoyment of the property, with the result that the property was not includible in the gross estate. Herzog v. Comm., 116 F 2d 591, 593 (2<sup>nd</sup> Cir. 1941). We conclude that the ability of this decedent to receive income and principal under the terms of the trust he created is not sufficient to require inclusion of the property under section 2036(a)(1) of the Code.

Private Letter Ruling 9332006 is somewhat similar to PLR 8037116 but involves offshore trusts, created by Americans in a jurisdiction where self-settled trusts are not subject to the claims of their grantor's creditors. The national office, again consistent with everything we have recited above, held that the trusts would not be includible in the estates of their grantors.

We are unaware of any case, ruling, GCM, IRS announcement or commentary, in any published article that suggests that the law is anything other than what we have recited. In fact, well-known commentators have reached the same conclusion. Stephens et al., in Federal Estate and Gift Taxation, para. 4.08[4][c], states in speaking of self-settled trusts:

Section 2036(a)(1) requires that the decedent retain either "possession or enjoyment" or "the right to the income." If he has no legal right to income, the "income" phrase would not support inclusion under Section 2036. Perhaps it may be said he has retained "enjoyment." However, if some meaning is to be accorded the word "retained," some showing of an arrangement, more than the fact that income was paid to the decedent, should be required... Since such transfers are treated as complete when made for gift tax purposes (see Rev. Rul 77-378...) there is even less reason for the imposition of estate tax liability under Section 2036. (Footnote numbers and footnotes other than n.42 omitted.)

Richard Covey, Esq., in Practical Drafting (July 1997), p. 4891, in discussing the Alaska Trust Act, says that

[i]f the grantor's retained interest is discretionary, creditors cannot reach the trust property, except as provided in the statute. Thus, under existing estate tax authority, the trust property would not be includible in the grantor's gross estate.

One thing we think is clear: Property transferred to a self-settled trust is not going to be subject to estate tax if the gift is complete. Moreover, the property is not going to be subject to gift tax if the property is going to be subject to estate tax when the grantor dies. Based upon the precedents recited above from the courts, the Service would face a virtually insurmountable wall in trying to convince the courts otherwise.

This information is not legal advice. You should contact an attorney for specific legal advice concerning the Alaska Trust Act.