Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1391

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From: Steve Leimberg's Estate Planning Newsletter

Subject: **Self-Settled Estate Planning Trusts - Part II**

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This LISI is part of a continuing series known as the **Modular Approach to Estate Planning**.™[1]

EXECUTIVE SUMMARY:

The first installment of this series, which was Part V of the reciprocal trust series, discussed the estate tax inclusion issue if the settlor/beneficiary retained an enforceable right to a distribution. See **LISI** Estate Planning Newsletter #1339. The second installment of this series, numbered 1 ½, discussed if there was an implied (i.e. oral) promise for the trustee to make distributions to the settlor whenever needed**. See LISI Estate Planning Newsletter #1370**.

This **LISI** begins the analysis of by far the most difficult estate inclusion issue – whether a creditor may reach the settlor/beneficiary's interest for a legal obligation.

FACTS:

BACKGROUND:

Prior to Alaska being the first state to pass a domestic asset protection trust ("DAPT") statute, the general rule was that *any* creditor could reach a beneficiary's interest in a self settled trust.[2] Therefore, the trust property would be included in the settlor's estate under Treas. Reg. § 20.2036-1(c)(1)(i).

A domestic asset protection trust statute protects a settlor/beneficiary's interest with spendthrift protection. Apart from exception creditors, spendthrift protection generally[3] prevents creditors from reaching a beneficiary's interest.

However, in addition to the exception creditor being able to reach a settlor/beneficiary's interest, which will be discussed in the next couple of installments of this series, there is also the issue of whether a settlor non-resident's beneficial interest is protected when he or she forum shops settling a trust in a domestic asset protection trust state.

This is a conflict of laws issue. Will a California judge apply the trust laws of California where the settlor/beneficiary lives and the cause of action is brought, or will the judge apply the laws of New Hampshire where the settlor settled his or her asset protection trust? Even *if* the California judge applies California laws, there most likely will be a declaratory judgment filed in New Hampshire, and New Hampshire courts will most likely rule that New Hampshire law governs the trust and beneficiary's rights.

Eventually, this conflict of laws issue will be decided by the U.S. Supreme Court. However, even then, it is most likely that the outcome will be highly fact dependent. In this respect, it may be uncertain when and whether a creditor of a non-DAPT resident may reach his or her interest in a DAPT.

The result is that the estate tax inclusion issue is *also* uncertain, most likely depending on a number of factors within the settlor's control.

CREDITOR CAN REACH THE ASSETS OF THE TRUST

Even if one planed around the "implied promise" Code Section 2036(a)(1) issues, the settlor of a self-settled trust *still* had an estate inclusion issue. Unlike the common law of the Isle of Man, Guernsey, and Jersey (the last two being the Channel Islands between England and France –nothing to do with New Jersey), prior to 1996 the common law of almost all states held that with self-settled trust, a creditor could reach the settlor/beneficiary's interest. Since a creditor could reach

the assets of a self settled trust, the result was automatic estate inclusion of the settlor/beneficiary's interest.[4]

In a domestic asset protection trust state, such state provides spendthrift protection for a self settled trust by statute. Assuming the following three requirements are met, it *may* be possible for a settlor/beneficiary to avoid estate inclusion of his or her interest in a self settled trust.[5]

(1) a creditor cannot reach the settlor/beneficiary's interest for payment of a legal obligation;

(2) the settlor holds a common law discretionary trust interest (i.e. where the beneficiary does not have an enforceable right to a distribution);[6] and

(3) the implied promise issues have been avoided,

CONFLICT OF LAWS

A DAPT statute will protect an in-state resident on an in-state action from a non-federal claim to the extent provided by the DAPT statute.

Conversely, it is *not* certain that a DAPT statute will protect an out-of-state resident from an out-of-state claim.

Some have expressed that there are asset protection concerns with DAPTs. These authors discuss the following two Constitutional issues that may greatly reduce the effectiveness of a DAPT: (1) the Full Faith and Credit Clause; and (2) the Supremacy Clause.[7]

However, there are those who take the position that with a properly formed and operated domestic APT, the forum court, under conflict of law issues, should apply the governing law of the trust.[8] In this case, a DAPT would work to protect an out-of-state resident from a state claim.[9]

Full Faith and Credit Clause

Under the full faith and credit clause, unless there is a strong public policy reason for *not* doing so, a sister state is *required* to respect another sister state's judgment.

Therefore, if a California court held that a creditor could reach a settlor/beneficiary's interest in a New Hampshire trust, a New Hampshire court is supposed to respect the California judgment (unless the strong public policy exception applies).

It is my opinion that in the example I've used, New Hampshire (or another DAPT state as the case may be) will most likely invoke the public policy exception, and *not* respect the California judgment. The likely result is this: Which state law should be applied and under what circumstances may well need to be determined by the U.S. Supreme Court.

Some proponents of domestic APTs have cited the U.S. Supreme Court case of *Hanson v. Denckla* as authority that, under conflict of laws, DAPT law will be applied. This case appears to be mis-cited. It is true that the original Delaware case and Florida case decided the issue under the conflict of law principles and each state came to the opposite conclusion over whose laws governed a revocable trust. Delaware held a Delaware revocable trust was valid under Delaware law, while Florida held it was against public policy under Florida law. It is also true that the full faith and credit argument was brought in front of the U.S. Supreme Court. Unfortunately, the Supreme Court decided the case under personal jurisdiction, and *not under* the full faith and credit clause.

In *Hanson v. Denckla*, a Delaware bank who was the trustee of the revocable trust never solicited any business in Florida by direct contact or mail, had no branch bank in Florida, and did not transact any business in Florida.[10] None of the revocable trust assets were located in Florida. Hence, the U.S. Supreme Court held that Florida did not have personal jurisdiction over the Delaware trustee, since there were no minimum contacts under the doctrine of *International Shoe v. Washington*.[11]

Today, with branch offices, seminars, mailers, webinars, and the internet soliciting out-of-state business, it may prove to be quite difficult for most domestic asset protection trust companies to avoid personal jurisdiction. [12]

Another most likely mis-cited case is *National Shawmut Bank v. Cummings*[13]. In *National Shawmut Bank*, the Massachusetts Supreme Court applied conflict of law principles to decide the case in favor of the Massachusetts revocable trust. I suggest that this is the natural result for a Massachusetts court to apply Massachusetts law regarding a Massachusetts revocable trust.

But the real issue is whether an *out-of-state* court would apply Massachusetts law. The National Shawmut Bank case was never heard by an out-of-state court. Therefore, the case stands for little authority that an out-of-state court or the Supreme Court will *automatically* apply the governing law of the trust to determine the state law to be applied.

Supremacy Clause

A second major concern with domestic asset protection trust legislation is the bankruptcy courts. The bankruptcy courts are federal courts that apply the law of the state in which they sit. What if a bankruptcy court sitting in California applies California law and holds that a creditor may reach the assets of an Alaska trust? Theoretically, federal law preempts state law, and the creditor will reach the assets of the Alaska trust.

At first glance, within the context of bankruptcy, the Supremacy Clause of the U.S. Constitution appears to be particularly detrimental to DAPTs. Generally, a bankruptcy court must apply the law of the state in which it sits.[14] If this were the case, domestic DAPTs would provide little, if any, asset protection to a non-DAPT resident in the bankruptcy context.

Yet, as contrary authority see *In re Remington*.[15] The Bankruptcy Court in *Remington* held that as applied to a New Jersey bankrupt, the state law of as to be determined by the Pennsylvania courts regarding spendthrift protection of certain Pennsylvania trusts should be applied.[16]

Little Clear Authority

At this point, there is little direct case law regarding exactly what factors and what weight a court will use to decide conflict to laws trust issues when creditor rights are involved either inside or outside of bankruptcy.

Gideon Rothschild, John Blattmachr, and **Dan Ruben** in their legendary law review article *A Few Bad Apples Should Not Spoil the Bunch*[17], devote considerable discussion that the classical rule regarding trust conflict of laws issues is that the governing law should control.

In the University of Denver's estate planning series, the author devotes some time to the discussion conflict of law principles under the First and Second Restatements on Conflict of Laws.

Finally, the Uniform Trust Code and the Restatement (Third) of Trusts, propose "the most significant relationship test" as the standard for deciding conflict of laws between trusts.

Richard Nenno and **John Sullivan** conclude that as to trusts, the primary principles under classic conflict of laws as well as the Restatements on Conflict of Laws should be substantially the same under the "most significant relationship test."[18]

While it is always possible for a judge who is not well versed in trust law to apply any factor to determine the most significant relationship, which in turn would determine the governing law and most likely the outcome of the case, [19] the following general statements may be made by synthesizing the above materials as well as commentary from well respected nationally recognized asset protection planning attorneys such as **Peter Spero** and **Duncan Osborne**.

a. It is much more likely that a judge from a non-DAPT state will apply the law of the DAPT state if most of the trust's contacts (i.e. factors) are with the DAPT state.

b. The following factors are listed in order of importance.

    (1) Governing law of the trust;

    (2) Place of administration of the trust;

    (3) Residence of the trustee;

    (4) Location of the trust property;

    (5) Residence of the settlor;

    (6) Residence of the beneficiaries; and

    (7) Any other factor.[20]

It should be noted that a similar list of factors was used by the Kansas Appellate Court to determine the most "significant relationship" for purpose of conflict of laws under the UTC.[21]

NO DIRECT CASE LAW

At this point in time, there is still no direct case law on whether domestic APTs "work" or "do not work" for out-of-state residents or out-of-state claims.

Even when the first case is decided, I question whether the holding of the case will answer this question, because most likely the holding will be fact specific based on the factors above. For example, assume that the governing law is Nevada, the trust is administered in Nevada, the sole trustee is in Nevada, all of the assets are in Nevada, the settlor and beneficiaries all reside in Colorado. Under these facts a court may well apply the laws of Nevada in a conflict of law analysis.

On the other hand, assume that while the governing law is Nevada, there is a co-trustee in Colorado, all of the assets of the trust are Colorado real estate, the settlor is the trust advisor or protector, and the settlor and all the beneficiaries are in Colorado. In this case a Colorado court may well apply Colorado law.

Furthermore, regardless if a Colorado court applies Colorado law, the entire issue will need to be appealed up both the Nevada and Colorado courts, assuming each holds that their law should apply. Eventually, the case could reach the U.S. Supreme Court. At this time, the U.S. Supreme Court's holding, as well as the Appellate Court's holding may well be very fact specific. It is my opinion, which should not be relied on as substantial authority or any authority for that matter, that if the governing law, the place of administration, all of the trustees, the protector, any trust advisors, and the trust property are located in the domestic APT state, the court would most likely apply the law of the domestic APT state.

CONCLUSION

For a DAPT that is designed to be a self-settled estate planning trust (i.e. a completed gift and excluded from the estate), there is an estate inclusion issue to the settlor if creditors may reach the settlor/beneficiary's interest.

For an out-of-state resident, there is the issue whether an out-of-state court will apply the law of its state or the DAPT state under conflict of laws principles. At this time, there is no trial court, appellate court, or U.S. Supreme court directly on point. There are some analogous cases and a great degree of theoretical

justification of how a court should apply conflict of laws principles, what factors a court should use, and what factors are more important.

With the reservations cited immediately above and the last end note, it is my opinion that, if the governing law, the place of administration, all of the trustees, the protector, any trust advisors, and the trust property are located in the domestic APT state, the court would most likely apply the law of the domestic APT state.

Unfortunately, even if an out-of-state court applies the law of the DAPT state or even for in-state residents, there *still* may be estate inclusion issues if certain "exception creditors" can reach the assets of the trust. The issue of exception creditors is discussed in the next few installments of this series.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Mark Merric

DUNCAN OSBORNE – TECHNICAL EDITIOR

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CITES:

[1] The modular approach to estate planning is trademarked by Mark Merric.

[2] Restatement (Second) of Trusts § 156(b); Restatement (Third) of Trusts § 60, comment f; Uniform Trust Code § 505.

[3] An exception creditor such as child support or alimony may reach a settlor/beneficiary's interest in many DAPT statutes. Also, spendthrift protection does not provide the superior protection of a third party common law discretionary interest.

[4] Treas. Reg. 20.2036-1(b)(2); *Estate of Paxton*, 86 TC 785 (1986); *Outwin v. Comm'r*, 76 T.C. 153 (1981) holding there was no completed gift; Rev. Rul. 76-103; and PLR 9646021. *But see Estate of Uhl*, 241 F2d 867 (7th Cir. 1957) and *Estate of German*, 7 Cl. Ct. 641 (1985) where the taxpayer was successful, because under the court's interpretation of state law, a creditor could not reach the settlor/beneficiary's interest.

[5] Naturally, all of the other estate inclusion issues must be avoided such as who can serve as trustee, limiting removal/replacement powers to persons independent with IRC § 672(c), as well as preventing the settlor from holding any powers of appointment that may cause an estate inclusion issue.

[6] The term "common law discretionary trust" refers to a discretionary distribution standard where a beneficiary does not have an enforceable right to a distribution. It does not refer to and must be distinguished from the virtually unsupported position at common law taken by the Restatement Third of Trusts where virtually all beneficiaries have an enforceable right to a distribution of a discretionary trust on an undefined continuum.

[7] Duncan Osborne, *Will Alaska Trusts Work*, Journal of Asset Protection 1997.

[8] Gideon Rothschild, Daniel S. Rubin, Johnathan G. Blattmachr, *A Few Bad Apples Should Not Spoil the Bunch*, (32 Vand. L. Rev. 763, 764 (1999)).

[9] That is to the extent spendthrift protection protects a beneficiary's interest and subject to any applicable exception creditors.

[10] The Delaware bank also did not use the internet to solicit business in Florida, because the internet and color television had not yet been invented.

[11] *International Shoe v. Washington*, 326 U.S. 310 (1945). In his treatise, *Commentary on Conflict of Laws*, 3rd Edition, the Foundation Press, Inc., Russell Weintraub notes that *"Hanson v. Denkla* was the first modern Supreme Court case to invalidate a state's exercise of jurisdiction."

[12] For a somewhat contrary position, see *Delaware Asset Protection Trusts Create Obstacles For Creditors* (under obstacle # 3), Richard Nenno and John Sullivan, Estate Planning Magazine, December 2005.

[13] *National Shawmut Bank v. Cummings*, 91 NE2d 337 (Mass 1950)

[14] *Butner V. United States*, 440 U.S. 48 (1979).

[15] *In re Remington*, 14 B.R. 496 (D.N.J. 1981).

[16] For a detailed discussion of how difficult it is for a creditor to file an involuntary bankruptcy as well, conflicting bankruptcy opinions, as well as how the bankruptcy analysis may well lead back to factor approach discussed in the "Little Clear Authority" part of this article see *Delaware Asset Protection Trusts Should Survive Bankruptcy*, Estate Planning Magazine, January 2006.

[17] A Few Bad Apples Should Not Spoil the Bunch, Gideon Rothschild, Daniel S. Rubin, Johnathan G. Blattmachr (32 Vand. L. Rev. 763, 764 (1999)).

[18] *Delaware Asset Protection Trusts Create Obstacles For Creditors* (under obstacle # 5), Richard Nenno and John Sullivan, Estate Planning Magazine, December 2005. See also Prof. Douglas Laycock's article (92 Columbia Law Review249 (1992)).

[19] Naturally, a judge in a divorce court (or any other court for that matter), who has virtually no knowledge of trust law and very little resources to get up to speed on the issues, could possibly find that a beneficiary or settlor living in their state is the most significant relationship, and then apply the law where the beneficiary resides. Of course, this type of arbitrary, expeditious, and most likely result oriented decision could be appealed. Conversely, if the client actively participated in fraudulent activity and then funded an APT, there is a good chance the court will ignore all conflict of laws principles and decide the case by applying the law detrimental to the debtor. *In re Lawrence*, 279 F. 3d 1294 (11th Cir. 2002); *In Re Portnoy, 201 BR 685 (Bankr. SDNY 1996); In Re Brooks, 217 BR 98 (Bankr. D. Conn. 1998).*

[20] Now this last factor (7) provides great certainty in how to plan transactions.

[21] In *Commerce Bank v. Bolanderand Whittet*, 2007 WL 1041760 (Kann. App. 2007) unpublished opinion.