**Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1370**

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**From:** Steve Leimberg's Estate Planning Newsletter

**Subject:** **Self-Settled Estate Planning: Trust Estate Inclusion Issues**

# Part I and ½

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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 part of this series regarding the estate inclusion issues and self-settled estate planning t`rusts was discussed in LISI Estate Planning Newsletter #1339 titled Estate Inclusion Issues of Reciprocal Trusts and Self Settled Estate Planning Trusts – The Doctrine of Reciprocal Trusts – Part V. That installment noted that there were three sub-tentacles to the estate tax octopus™[2] of IRC § 2036(a)(1), and discussed the first inclusion issue: if the settlor/beneficiary has an enforceable right to a distribution. This installment discusses the second sub-tentacle of the estate tax octopus™: whether there is an implied promise that the trustee will distribute assets to the settlor whenever he or she needs them. The second and following installments of this series will discuss the third sub-tentacle: whether a creditor can reach the settlor/beneficiary's interest for a legal obligation of the settlor.

Prior to the creation of domestic asset protection trust statutes, as one argument for estate tax inclusion, the Service was successful in including self-settled trusts in the settlor's estate under the implied promise theory of Treas. Reg. § 20.2036 using the following three lines of cases:

(1) Continuous distributions were made to the Settlor for living expenses;

(2) Substantial distributions were made to the Settlor; or

(3) The Settlor transferred almost all of his or her net worth to the trust.

Since then, the Service has used the same factors resulting in estate inclusion in the family limited partnership ("FLP") or limited liability ("LLC") arena. However, similar to planning with FLPs or LLCs, if the estate planner is careful in the design and implementation of a self-settled estate planning trust, the implied promise sub-tentacle of the estate tax octopus may be avoided.

# Implied Promise

Prior to the Service's first successes in attacking some FLPs under IRC § 2036, much of the case law for recovery under the implied promise theory involved a tax scam commonly known as the Constitutional, pure, equity, apocalypse, or contract trust ("Constitutional Trust"). With these trusts, the settlor was also a beneficiary of the trust (i.e. self-settled trust). Promoters claimed that neither the settlor (nor the trust) paid any income tax, because the settlor did not control anything. There was no gift tax because the settlor was transferring property in exchange for beneficial shares. Finally, there was no estate tax because the settlor, who was also a beneficiary of the trust, held nothing more than a mere expectancy of a distribution. The income tax benefits of these trusts were false due to the grantor trust rules, as well as assignment of income cases. The gift tax benefits were also false.[3] On the other hand, under common law a discretionary interest in trust is not a property interest and a beneficiary does not have an enforceable right to a distribution. Therefore, unless there is some other estate tax inclusion rule, the Constitutional Trust would escape estate taxation. As one method to force inclusion of the Constitutional Trust into the decedent's estate, the Service used the following three lines of cases based on an <u>oral promise</u> (i.e. implied promise) between the settlor and the trustee so that the trustee would make a distribution to the settlor/beneficiary whenever he or she requested a distribution:

(a) Continuous distributions were made to the Settlor;

(b) Substantial distributions was made to the Settlor; and

(c) The Settlor transferred almost all of his or her net worth to the trust.

## <u>Continuous Distributions Were Made to the Settlor</u>

Similar to many family limited partnership cases,[4] continuous distributions to pay the settlor's living expenses resulted in the court finding that there was an implied oral promise that the trustee would make distributions to the settlor whenever needed. In *Estate of Skinner*[5], the Third Circuit held that <u>discretionary</u> distribution of all the income of the settlor was a retained life interest under the implied promise theory of § IRC 2036(a)(1). In *Estate of Marguerite Green*[6], the settlor/beneficiary received discretionary distributions of close to $24,000 a year, which

exceeded the annual income of the trust. The date of death value of the trust of over $1.1 million was included in the descendant's estate under the implied promise theory.[7] It was not the mere fact that distributions were made to the settlor that resulted in estate inclusion, rather it is the purpose for which the distributions were used – to pay living and anticipated medical expenses of the settlor.

On the other hand, trust property was not included in the settlor/beneficiary's estate when the distributions were not used for ordinary and necessary living expenses. In *Estate of Wells*[8] distributions were made for travel. For this reason, the trust was not included in the settlor/beneficiary's estate even though she received continuous distributions.

This oral implied line of cases may be easily avoided by simply not making distributions for the settlor/beneficiary's ordinary and necessary living expenses. However, this creates a pragmatic problem. As one of the major benefits of a self-settled estate planning trust, settlors are generally told that should they need the assets due to misfortune, the trustee may make distributions back to the settlor. Generally, if a client has a misfortune, the purpose for requesting a distribution will be for the settlor's ordinary and necessary living expenses. Naturally, if the entire trust property is distributed to the settlor, there is no issue, because if it is not consumed, it will be included in the settlor's estate. On the other hand, if the settlor's current financial distress is only a temporary issue, the settlor's estate may wish the trustee to document this by resolution. Later, distributions may be made for non-support reasons. This should distinguish the distributions to the settlor from the Constitutional Trust cases and bad fact family limited partnership cases that resulted in estate inclusion where the distributions for ordinary living expenses were continuous through the settlor's life.

## Substantial Distribution of the Trust Assets

The second bad fact pattern is when the trustee makes substantial distributions to the Settlor. In *Estate of McCabe*[9], husband and wife contributed property to a joint irrevocable trust. Both were settlors, and the wife was named as a discretionary beneficiary. Immediately after the descendant retired, substantial distributions (most of the trust assets) were made to the descendant's wife. The substantial distributions coupled with the trustee being the descendant husband's life long friend and depositing the funds into the descendant husband's checking account resulted in inclusion of the trust under the implied promise theory.

A somewhat analogous argument for estate inclusion occurred with the family limited partnerships. With many of these bad fact cases, even with a minority/marketability discount, the settlor individually did not have near sufficient assets to pay the estate tax. A distribution, liquidation, or purchase of the settlor's partnership interest would be required to pay the settlor's estate tax. The analogy being a substantial distribution from the partnership would be needed to pay estate tax.[10]

Again, similar to FLPs and LLCs, this line of cases may be avoided by making sure that the settlor retains enough assets to pay his or her estate tax, living expenses, and medical expenses. Further, the settlor should not request substantial distributions for a new house, boat, or personal items. Investments and other business opportunities may be owned directly by the trust. Thus, generally a distribution does not need to be made for these items.

On a side note, the court in *Estate of McCable* mentioned the relationship of the trustee to the settlor as a bad fact. A best friend is independent within the meaning of IRC § 672(c), and under Revenue Ruling 95-58, the trustee's powers cannot be attributed to the settlor. However, this is not the point that the Service was making in *Estate of McCabe*. As one of the factors pointing to an implied oral promise, the relationship of the trustee being the settlor's best friend was used as a factor to show an implied promise. In an LLC case, the Tax Court noted the closeness of all the trustees to the Settlor.[11] Fortunately, almost all domestic asset protection trusts avoid this potential side issue, because the trustee is typically a corporate trustee or an individual residing in the asset protection jurisdiction who is not related to the settlor.

### <u>Transferring Almost All of the Settlor's Assets to the Trust</u>

Finally, in *Estate of Paxton*[12], under the third line of cases, the transfer of most of the settlor's assets at a time when the settlor would be going into retirement and would need such assets, was the primary reason the Tax Court held there was an implied promise. As one of the major reasons for finding an implied promise, the Tax Court in *Paxton* held:

> "Mr. Paxton was a wealthy man accustomed to living well. He transferred to the trust all of his property, including even his household furniture, except his patent licensing agreements that paid him from about $100,000 to $196,000 per year until his death. Apart from these royalties and small amounts of income from consulting fess, interest, and distributions from PFO and IDT [the two constitutional – self settled trusts he created], he had no income. The royalties would cease on the expiration of the patents in 1982. At that time, decedent would have only been 64 years of age. We do not think he would have left himself virtually destitute at that age *without the understanding that he would receive income or corpus or both from the trusts when and as needed."* [emphasis added]

While there are not many cases on this issue in the self-settled trust context, there are many analogous cases in FLP and LLC areas.[13] These cases constantly discuss that the settlor left themselves incapable of paying his or her living expense by transferring almost all of his or her assets to an FLP or LLC. Again, this third implied promise line of cases may be avoided by leaving enough assets in the settlor's individual name to make sure that any estate tax as well as living expenses are paid.

## The Golden Offshore APT PLR 9332006

The first installment of this LISI – Estate Planning Newsletter #1339 discussed if a settor/beneficiary had an enforceable right to a distribution, there was an estate inclusion issue. This LISI discusses three lines of cases under an implied promise resulting in estate inclusion. To date, there have been three requests for PLRs regarding the efficacy of a self-settled estate planning trust. The first request, PLR 9332006, with an offshore APT was approved by the Service.

Some of the key factors stipulated and relied upon by the Service were as follows:

> ". . . neither a beneficiary or any creditor of any beneficiary, including the Settlors, may compel the trustee to distribute the Trust's assets to or for their benefit at anytime during the trust term; that transfers by the Settlors of the interests in the Partnership to the Trust are not in any way liable to be set aside under any applicable fraudulent conveyance or other law, domestic or foreign; that neither the Trustee nor the Settlors have any plans to hold Trust assets anywhere other than Country X . . . "

As noted from the above stipulated facts, the Service addressed the issue that the settlor/beneficiaries did not retain any ability to force a distribution from the trust. When determining that the transfer to the trust was a completed gift, the Service cited Rev. Rul. 77-378 stating:

> ". . . even though a trustee may have an unrestricted power to return all of the trust's assets to the grantor, if the grantor's interest in the trust is not enforceable either by the grantor or on the grantor's behalf, then the grantor has parted with dominion and control over the property transferred to the trust. Furthermore, if the grantor retains a mere expectancy that the trustee will distribute the trust assets to the grantor rather than an enforceable interest in the trust, the expectancy does not prevent the completion or reduce the value of the gift."

The Service also held that based on the stipulated facts, the settlor/beneficiary's interests were not included in the settlor's estates. Unfortunately, it is here where some of the analysis is missing. The fact pattern in the PLR also dealt with some *Byrum*[14] fiduciary issues, since a domestic partnership that held non-voting shares in a C corporation were being contributed to the trust. The Service ruled that the settlors as shareholders of the general partner had fiduciary duties with respect to the limited partners: there was no estate inclusion issue under IRC § 2036(b). The Service did not analyze any potential estate inclusion issue under the implied promise sub-tentacle of IRC § 2036(a)(1).

After Alaska passed the first domestic asset protection trust statute, the settlor of an Alaska self-settled estate planning trust requested a similar ruling. This time the Service ruled that transfers to the trust were a completed gift. However, the Service would not rule on whether the trust was excluded from the settlor's estate.[15] Part of the reason the Service may not have ruled regarding the estate issue is that the Service would not know at the inception of the trust whether there would be either continuous distributions for living expenses or a substantial distribution from the trust. In this respect, the golden PLR issued for an offshore asset protection trust was probably a bit premature. It is not until the settlor dies that one knows whether two of the three lines of implied promise trust cases were violated.

# Conclusion

Similar to FLP or LLC estate planning, continuous distributions for living expenses, substantial distributions of the trust assets, and gifting away almost all of a settlor's assets at a time when he or she would need them the most, all three of these, become planning issues that must be addressed to avoid the estate tax octopus sub-tentacles. From the design side, the estate planner should compute the clients anticipated living expenses, including medical expenses, through the

client's life expectancy and leave enough assets in the settlor's name to individually pay these expenses. Even after making this computation, the settlor should not contribute substantially all of his or her assets to a self-settled estate planning trust. Rather, other estate planning tools should be utilized. As noted by some planners, the term "rainy day"[16] is most appropriate, where only a nest egg is used to fund the self-settled estate planning trust.

The design of the self-settled estate planning trust is only half of the battle in avoiding the oral implied promise sub-tentacle of the estate tax octopus. Whether the trustee makes continuous distributions for living expenses or a substantial distribution, both of these operational issues need to be monitored over the life of the trust.

In the event that the settlor does not have an enforceable right to a distribution and the settlor avoids the oral implied promise issues, two of the three sub-tentacles of the estate tax octopus under IRC § 2036(a)(1) have been avoided. However, it is the third sub-tentacle, whether a creditor may reach the settlor/beneficiary's interest in a self-settled estate planning trust that is the hardest sub-tentacle to escape from. The next few parts to this series shall discuss this estate inclusion issue.

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

***Mark Merric***

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1 The term "modular approach to estate planning" is trademarked by Mark Merric.

2 The term "estate tax octopus" is trademarked by Mark Merric.

3 The beneficial shares received by the settlor did not give the settlor any rights to vote the shares, any rights to a distribution, or any rights to liquidation proceeds. In simple terms, the settlor transferred property to the Constitutional Trust in exchange for nothing. The transaction was nothing more than a red herring diverting the planner to think about corporate and partnership transfers where a code section (§ 351 and § 721) prevents gain recognition. There is no non-recognition provision for a trust. Rather, a transfer of property to a trust in exchange for a beneficial share with no value is nothing more than a gift.

4 This factor, among others, was present in ten of the twelve FLP cases that were decided against the taxpayer under the implied promise theory of IRC § 2036(a)(1). *Estate of Schauerhamer,* TC Memo 1997-242; *Estate of Reichardt,* 114 TC 144 (2000); *Estate of Harper,* T.C. Memo 2002-121; *Estate of Thompson,* TC Memo 2002-246; 382 F.3d 367 (3rd Cir. 2004); *Estate of Strangi,* TC Memo 2003-145; *Estate of Hillgren,* TC Memo 2004-46; *Estate of Korby,* TC Memo 2005-103; 471 F.3d 848 (8th Cir. 2006); *Estate of Rosen,* TC Memo 2006-115; *Estate of Bigelow,* 503 F.3d 955 (9th Cir. 2007); *Estate of Erickson,* TC Memo 2007-107.

[5] *Estate of Skinner,* 197 F. Supp. 726 (3rd Cir. 1963).

[6] *Estate of Marguerite Green*, 64 TC 1049 (1971).

[7] Also see, *Estate of Boardman*, 20 T.C. 871 (1953).

[8] *Estate of Wells*, TC Memo 1981-574.

[9] *Estate of McCabe,* 475 F2d 1142 (Ct. of Claims 1964).

[10] This factor, among others, was present in eight of the twelve FLP or LLC cases that were decided against the taxpayer under the implied promise theory of IRC § 2036(a)(1). *Estate of Harper,* T.C. Memo 2002-121; *Estate of Thompson,* TC Memo 2002-246; 382 F.3d 367 (3rd Cir. 2004); *Estate of Strangi,* TC Memo 2003-145; *Estate of Hillgren,* TC Memo 2004-46; *Estate of Rosen,* TC Memo 2006-115; *Estate of Bigelow,* 503 F.3d 955 (9th Cir. 2007); *Estate of Erickson,* TC Memo 2007-107; *Estate of Rector,* TC Memo 2007-367

[11] *Estate of Bongard,* 124 TC 95 (2005).

[12] *Estate of Paxton*, 86 TC 785 (1986).

[13] This factor, among others, was present in six of the twelve FLP or LLC cases that were decided against the taxpayer under the implied promise theory of IRC § 2036(a)(1). *Estate of Reichardt,* 114 TC 144 (2000); *Estate of Thompson,* TC Memo 2002-246; 382 F.3d 367 (3rd Cir. 2004); *Estate of Strangi,* TC Memo 2003-145; *Estate of Korby,* TC Memo 2005-103; 471 F.3d 848 (8th Cir. 2006); *Estate of Rosen,* TC Memo 2006-115; *Estate of Bigelow,* 503 F.3d 955 (9th Cir. 2007).

[14] *U.S. v. Byrum,* 408 U.S. 125 (1972).

[15] PLR 9837007; In 1999, the settlor of a Delaware APT requested a PLR. This time the Service refused to rule on whether the transfer to the trust was a completed gift or excluded from the estate. TAM 199917001. The reasons why the Service could most likely not rule on whether a transfer to a domestic APT is a completed gift will be discussed in the upcoming installments of this series.

[16] The term “Rainy Day Trust™” is trademarked by Alaska Trust Company.