SPECIAL TAX FEATURE

Possible Estate Planning Strategies Arising From The Tax Cuts and Jobs Act

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The Tax Cuts and Jobs Act (TCJA), signed into law on December 22, 2017, and effective as of January 1, 2018, increased the lifetime gift tax exemption from $5 million ($5,490,000 for 2017 as adjusted for inflation) to $10 million ($11,180,000 for 2018 as adjusted for inflation). This increase presents planners and their clients with a tremendous opportunity to transfer more wealth without paying any federal transfer tax. For some clients, the tax changes will allow them to transfer additional sums to already existing irrevocable trusts, or to reduce any outstanding debts by reducing or eliminating existing promissory notes. Other clients may terminate QTIP trusts or use their exemptions on new planning strategies altogether.

It is anticipated that many clients will be eager to use the added exemption due to concerns that the federal gift and estate tax exemptions may "snap back" to pre-2018 levels. However, it is also anticipated that a significant hurdle for many clients will be reluctance to transfer assets without the possibility of receiving the transferred assets back in the future if faced with hard economic times. For those clients, there are a number of planning opportunities to consider, including: "self-settled spendthrift trusts," Spousal Limited Access Trusts ("SLATs"), or Inter Vivos QTIP's that might offer answers.

General Tax Considerations

Treasury Regulation Section 25.2511-2(b) provides that a gift is complete if the donor "has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another...." Courts have consistently held that gifts to self-settled spendthrift trusts are not complete in jurisdictions that allow a settlor's creditors to reach the maximum amount that the trustee could distribute to the settlor. These courts reasoned that the settlor retained a beneficial interest in the assets, because the settlor could incur debt, and the settlor's creditors could thus reach the trust assets to satisfy these obligations. Another way to describe the courts' view is that the settlor, indirectly, has retained the economic access to the trust assets through the ability to "run up" debt.

The Internal Revenue Service ("IRS") reached a similar result in Revenue Ruling 76-103, holding that a transfer to a self-settled spendthrift trust was an incomplete gift because local law subjected the entire property of the trust to the claims of the grantor's creditors whenever such claims arose. Thus, when determining whether a transfer is a completed gift, the focus of the IRS and the courts is on whether the settlor's creditors could have reached the discretionary income or principal distributable to the settlor/beneficiary.

In contrast, when local law prevents a settlor's creditors from reaching the assets of a self-settled spendthrift trust, courts have held that a gift to such trust, absent some retained interest or power, is complete for federal gift tax purposes. The IRS took a similar approach in Revenue Ruling 77-378, where local law prohibited a settlor's creditors from reaching the assets of a self-settled spendthrift trust, despite the fact that the trustee was given "absolute and uncontrolled discretion" to distribute income and principal to the settlor. The ruling concluded that even though a trustee may have an unrestricted power to distribute all of the trust assets to the settlor, if the settlor's interest in the trust is not enforceable either by the settlor or on his behalf, the settlor has parted with dominion and control, and the gift is complete. The ruling further states that a mere expectancy that the trustee will distribute the trust assets to the settlor does not prevent the completion of the gift or reduce its value.

Thus, it appears the determination of whether a transfer of assets as part of an estate planning strategy is a completed gift for federal gift tax purposes is based upon the law of the state where the trust or other planning vehicle is established.

While 17 states have adopted legislation that validates self-settled spendthrift trusts (sometimes referred to herein as Domestic Asset Protection Trusts, or "DAPTs"), there is evolving legal authority that a taxpayer who resides in a non-DAPT state might not be deemed to have made a completed gift to a trust settled in a DAPT state, or that if there was a completed gift, nevertheless, the assets in the DAPT may be included in the taxpayer's gross estate upon death.

For DAPT planning purposes, Florida does not afford creditor protection for settlors of self-settled spendthrift trusts. As part of the Florida Trust Code, Fla. Stat. §736.0505(1)(b) codified Florida's adoption of the common law rule that "no man can live in luxury and in debt at the same time," by directing that "a creditor or assignee of the settlor may reach the ***maximum amount that can be distributed to or for the settlor's benefit.***" (emphasis added).

Self-Settled Spendthrift Trusts: Creation And Tax Issues

Assume a settlor transfers all of his/her right, title, interest, dominion and control over assets to an irrevocable trust, pursuant to the terms of which an independent trustee has the discretion to distribute all or a portion of the income or principal to the settlor as one member of a class of beneficiaries. The trust is designed with a spendthrift clause and is intended to shield the assets from the settlor's creditors.

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Aside from the asset protection advantages of self-settled spendthrift trusts, the transfer of assets to a self-settled spendthrift trust can be structured as completed gifts to use the newly increased federal transfer tax exemption.

Whether such a transfer will be treated as a completed gift, and thereby cause the exclusion of the trust assets from the settlor's gross estate for federal estate tax purposes, depends on the trust law of the state or country in which the trust is created, as well as the applicable sections of the Internal Revenue Code and the rulings and case law interpreting such sections. Therefore, if the trust assets are in fact protected from the claims of the settlor's creditors, and if such a trust is otherwise properly drafted to avoid inclusion in the estate of the settlor, then this type of self-settled spendthrift trust should not be included in the client's estate.

On the other hand, if the assets in the self-settled spendthrift trust are available to the creditors of the settlor, then under Sections 2036 and 2038 of the Code, the trust would be included in the settlor's estate.

So, the difficult questions arise when Florida residents seek to form DAPTs in states that permit them. Under such circumstances, the issue is whether a court will apply the law of the nonresident settlor's domicile rather than the DAPT law selected in the trust instrument. Assume, for example, a Florida resident establishes a self-settled spendthrift trust in a DAPT state. Subsequently, the settlor is sued in either the state of residence or in federal court. The federal court may be located in the settlor's state or in the DAPT state. Further assume that the court obtains jurisdiction over the trustee of the DAPT. The party suing the settlor ("creditor") will presumpably argue that the court should choose the spendthrift trust law of the settlor's state of residence, rather than the law of the DAPT state. If the court opts to apply the law of the settlor's state of residence—which does not provide asset protection for DAPTs—then the creditor may be allowed to reach the trust assets. If that's the case, then as a result of the assets being available to the creditors of the settlor, the tax consequence would be that these were not completed transfers for federal and gift tax purposes, and all of the trust assets would be included in the settlor's gross estate.

Choice of Law

The Full Faith and Credit Clause along with the substantive due process protections under the Fifth and Fourteenth Amendments to the United States Constitution restrict a forum state's ability to apply its own law to disputes between outsiders.

(a) The forum state must have "significant contact" with the dispute that creates "state interests," such that the use of the forum's law is not "arbitrary or unfair."

(b) The Restatement of Conflict of Laws states that the forum state should apply another state's laws if that state has the dominant interest in the question of exemption. If the debtor and creditor are domiciled outside the forum state, "a state to which they both have substantial relationships may be the state of dominant interest."

(c) The Due Process Clause merely mandates that the forum state must have sufficient interests in the matter that the application of its laws would not be arbitrary or unfair.

In re *Huber*, the debtor, Donald Huber, was a real estate developer and a lifelong resident of the State of Washington. When Huber realized that many of his real estate projects were about to fail and be foreclosed upon, and his personal guarantees called, he transferred substantially all of his assets into an Alaska limited liability company ("LLC") and transferred a 99% LLC membership interest into the Donald Huber Family Trust, an irrevocable self-settled spendthrift trust in Alaska. The assets with which the LLC was capitalized were situated in Washington, and the trust was funded with the LLC membership interest and a $10,000 certificate of deposit situated in Alaska. The beneficiaries of the trust were Huber and his descendants, all of whom were residents of Washington. Whereas Alaska law recognizes and validates self-settled spendthrift trusts, Washington law deems them to be contrary to public policy.

The bankruptcy judge found that Alaska law would apply if Alaska had a substantial relation to the trust. However, Alaska was determined to have had only a minimal relation to the trust, despite the LLC being formed under Alaska law and the certificate of deposit being situated in Alaska; whereas, Washington had a strong public policy against self-settled spendthrift trusts. Therefore, since the trust was a self-settled trust, the transfers into the trust were void.

While the issue of which law to apply is still somewhat unclear, if the *Huber* decision resonates and accurately states the law, then residents of Florida cannot create DAPTs and expect them to be completed gifts and outside of their taxable estates.

SLATs

An estate planning strategy recommended under the new tax regime is the so-called "Spousal Lifetime Access Trust," or "SLAT." The basic concept of the SLAT is simple and straightforward – it would function like a bypass or credit shelter trust, but be funded during life instead of at death, with the intention of using it to take advantage of the $11.18 million estate tax exemption before it drops back to $5 million (adjusted for inflation) as is scheduled in 2026.

Essentially, the SLAT allows a donor/spouse to create a lifetime "credit shelter trust" for the benefit of a spouse and issue, funded with the donor/spouse's federal gift tax exemption. So, the SLAT is an effective vehicle to utilize clients' gift exemptions as the gifted assets and all appreciation thereon, remain outside the taxable estate of the donor/spouse, the donee/spouse, and the issue of the donor.

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This technique should work well to allow a client to use the exemption comfortably knowing the funds can be used not only for descendants but also for a spouse. However, the comfort can be somewhat tenuous as the funds will become unavailable to the client if the spouse dies.

The problem arises under Florida law upon the distribution of the principal of the SLAT in the event the donee/spouse predeceases the donor/spouse. If the donor/spouse is the remainderman, the retained interest would cause the trust principal to be subject to the donor/spouse's creditors under Fla. Stat. §736.0505(1)(b). That would be the result even if the donee/spouse has a testamentary power of appointment in favor of the donor/spouse and issue, because a creditor of the donor/spouse may "reach the maximum amount that *can be distributed to or for the settlor's benefit."*

The primary purpose of Fla. Stat. §736.0505(1)(b) is to protect against recognition of "self-settled spendthrift trusts" by which a settlor could give to a trustee all of his/her dominion and control over his/her assets but retain a discretionary right to income and/or principal in the discretion of the trustee. Although the primary focus was to avoid the use of such trusts for asset protection purposes, an additional result, intended or not, is to limit the ability to engage in certain estate planning strategies.

Therefore, if the settlor resides in Florida, since local law subjects the entire property of such a trust to the settlor's creditors, the transfer of assets to an irrevocable trust in which the settlor has a contingent remainder interest would arguably be incomplete for federal gift tax purposes.

Inter Vivos QTIP Trusts

Alternatively, assume a settlor transfers all of his/her right, title, interest, dominion, and control to a trust for the benefit of his/her spouse, from which the spouse is entitled to all of the income for life, and the trust qualifies as "qualified terminable interest property" for marital deduction purposes. In fact, the settlor has no retained current interest in the trust, but only a contingent right to an interest in the trust if the spouse predeceases and fails to exercise a power of appointment. This structure is often referred to as an "Inter Vivos QTIP Trust". Treasury Regulation §25.2523(f)-1(f), Example 11, addressed the issue of whether the trust principal would be included in the donor/spouse's estate as a gift with a retained interest. Because the donor/spouse makes the QTIP election, on the donee/spouse's death, the trust property is included in the donee/spouse's gross estate and, therefore, the donee/spouse is deemed the transferor of the property at death. Because the donee/spouse is treated as the transferor of the property, even if the assets fund a "spend thrift" type trust for the benefit of the original donor/spouse, the property in the trust is not subject to inclusion in the donor/spouse's estate under Section 2036 or 2038.

Before the enactment of the exemption under Fla. Stat. §736.0505(3), it was unclear whether assets contributed to an Inter Vivos QTIP Trust in Florida would nonetheless be subject to estate tax upon the donor/spouse's death because under local law, a creditor of the donor/spouse may reach the maximum amount that can be distributed for the donor/spouse's benefit.

Fla. Stat. §736.0505(3) was passed and created an exception to the general rule that a creditor of the settlor of an irrevocable trust may reach the maximum amount that can be distributed to or for the settlor's benefit. The exception deals with a lifetime irrevocable trust described in Section 2523(e) of the Internal Revenue Code (life estate with power of appointment in the donee/spouse), or a trust for which an election under Section 2523(f) ("qualified terminable interest property" trust) has been made. The exception is intended to parallel the effect of Treasury Regulation Section 25.2523(f)-1(f), Example 11, to assure that no portion of the trust principal will be included in the donor/spouse's estate since the property is deemed passing from the donee/spouse's estate, rather than the donor/spouse.

Therefore, a Florida resident might use an Inter Vivos QTIP trust plan to transfer assets out of the resident's name and might be able to be the beneficiary of the trust after the spouse dies if the trust is included in the estate of the donee/spouse.

However, this is not an ideal tax planning tool, as all appreciation on the assets used to fund the Inter Vivos QTIP trust will be included in the donee/spouse's estate, thus making all the growth taxable. Therefore, while this technique might allow a Florida resident to transfer assets to a trust for a spouse and elect to QTIP the trust, and while the resident settlor of the trust might be a permissible beneficiary of the trust after the donee/spouse's death, all of the assets, and their appreciated value, will be included in the donee/spouse's estate.

Further, as a result of the inclusion in the donee/spouse's estate, if the donee/spouse lives past 2025, and if the exemption "snaps back," this Inter Vivos QTIP plan would not have helped the clients use the new increased exemption. Therefore, the Inter Vivos QTIP plan is likely not going to be a desirable approach to using clients' increased exemptions.

Going Off-Shore – Foreign Asset Protection Trusts

If a self-settled spendthrift trust sounds like the appropriate planning concept for a Florida client, but if the planner hesitates to use a DAPT due to concerns for the efficacy of DAPTs (as described above), perhaps off-shore self-settled spendthrift trusts ("FAPTs") offer a better solution. Unlike DAPTs, FAPTs are not subject to the same US Constitutional concerns (the full faith and credit and due process concerns). Instead, FAPTs have a long history of avoiding the claims of creditors.

While the motivation for creating a FAPT in this circumstance may not be creditor protection, the asset protection aspects

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of FAPTs is what makes them ideal for planning to utilize one's gift and estate tax exemption, because the success of FAPTs in stopping creditors' claims is the key to their success in estate planning. As noted, if a client creates a self-settled spendthrift trust that is a completed gift and not available to the client's creditors, then the client should be able to use the new exemption while still being a permissible beneficiary of the trust – and that's likely the ultimate planning goal for many clients.

Therefore, while Florida does not recognize DAPTs, it would appear a Florida resident can create a properly drafted FAPT and avail oneself of the estate and gift tax planning benefits of using one's exemption on the transfer while remaining a potential beneficiary of the creditor-protected, self-settled spendthrift trust.

Conclusion

Although self-settled spendthrift trust legislation has not been adopted in Florida, there are still opportunities for Florida clients to use the increased gift and estate tax exemption using some of the estate planning opportunities outlined herein – primarily SLATs and FAPTs.

Endnotes

1 *Huber*, 493 B.R. 798 (Bankr. W.D. Wash. 2013).

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