CREDITOR PROTECTION PLANNING TECHNIQUES

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Table of Contents

A. EXAMPLES OF STATE LAW CHANGES. 1

IRAs, Qualified Plans, Insurance, Annuities, 529 Plan Exemptions. 3

B. RECENT CASES AND OTHER LAW CHANGES. 3

Bankruptcy 10 Year Look Back Rule for Self-Settled Trusts: 11 U.S.C. Section 548(e). 3

In re Mortensen. 4

In re Porco, Inc. 4

In re Yerushalmi. 5

Interstate Trust Issues: Choice of Law and Public Policy. 5

Downside to Being Too Cute. 6

Lessons. 7

C. PLANNING: 7

Spousal Lifetime Access Trusts (Arizona law is assumed applicable in this discussion and is typical of most states). 7

Reacquisition of SLAT Interest - Creditor Issue. 8

Reacquisition of SLAT Interest - Estate Tax Issue. 9

Best Mode of Donor Spouse SLAT Interest Reacquisition. 10

Reciprocal Trust Issue. 10

Common Law Reciprocal Trust Doctrine. 10

Unique Rule in Arizona. 12

Estate Tax Reciprocal Trust Doctrine 12

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The rapid evolution of modern trust law has made use of trusts more valuable and important as a means to control taxation, property, and rights and powers of creditors. Many states have enacted legislation and revised trust and other law to clarify and in many instances expand the protection given to trust beneficiaries. However, as with many deemed legal advances, the flip side is that someone or something is adversely affected as a result. The theories of creditor attack upon asset protection techniques are also evolving.

The downturn in the economy and the fear and concern about what may come has made many more defensive. Part of that change in outlook manifests itself in fortifying methods to protect wealth already acquired and that may be acquired. Protection against the reach of creditors as well as from decline of investment and asset value are natural and expected reactions.

Much more asset protection trust planning can and is occurring as a result of the increase and permanence of the federal gift tax exemption, which is $5,250,000 in 2013. One of the reasons for this is that now it is not necessary to efficiently use the exemption for wealth transfer purposes, except for sizable estates in excess of $5,000,000, or in excess of $10,000,000 for married couples. Planning for asset protection often involves trusts and gifting. Much of that entails taxable gifts. Previously the gift tax exemption of $1,000,000 constrained this planning because it was needed for the most efficient generational wealth transfer. Now for many but the most wealthy, there is more exemption than necessary for their estate tax planning needs. The excess can be used effectively for protecting assets for the current generations when it is not otherwise safely held.

The use of trust, ownership of exempt property, such as life insurance and annuities, is more readily considered.

A. EXAMPLES OF STATE LAW CHANGES.

Arizona is in some respects typical of law changes made in the last few years in many states to codify the trust law and to provide more certainty of the protection that is given to beneficiaries of trusts. In some instances, the law follows the rules applicable to the majority of states. But in other instances, the protections legislated are greater than those of most other states. There is an important exception – more and more states specifically authorize individuals to fund or settle trust for their benefits, yet prevent creditors from reaching the trust assets. Such trusts are often referred to as "self-settled trusts," and the legislation authorizing them is referred to as Domestic Asset Protection Trust state statutes, or "DAPTs." However, those statutes are subject to the supremacy of relatively new federal bankruptcy legislation specifically designed to make much of those statutes of questionable value. This bankruptcy legislation is discussed further below.

Here is a summary of the more important Arizona rules regarding the rights of trust beneficiary creditors:[1]

1. A revocable trust can be reached by the settlor's creditors.
2. Creditors of the settlor can reach the maximum amount the trustee of an irrevocable trust can pay to or for his benefit, without taking into account the exercise of a power of appointment held by someone other than the settlor or the trustee.
3. Creditors of a decedent and decedent's estate can reach the decedent-settlor's revocable trust.
4. A holder of a power to withdraw under a trust is the deemed settlor of a revocable trust holding the property subject to the power during the time it is exercisable.
5. Creditors cannot reach amounts the trust determines to pay to reimburse the settlor for income taxes attributable to income of the trust.
6. Creditors of the settlor cannot reach amounts paid directly to taxing authorities.
7. A trust settled by a business entity, government or charity is not settled by its owners, fiduciaries or employees, unless the trust that has no valid business purpose and that has as its principal purpose the evasion of the claims of the creditors of the owners, fiduciaries, employees or the entity.
8. A settlor of a trust for his spouse is not a settlor if he reacquires rights in the trust he created for his spouse after the spouse dies.
9. A person is not the settlor of a trust created by his spouse as a result of creating a trust for the spouse.[2]
10. The settlor of a trust is not the settlor to the extent another has had a general power of appointment over the trust.
11. A person is not a settlor of a trust in excess of the person's share of contributions to the trust.

The above descriptions are rough statements of the statute. The first four rules confirm the rights of creditors, and follow the common law of trusts. The remainder of them are

[1] Distilled from ARS Section 14-10505.

[2] In other words, apparently a beneficiary of a trust funded by his spouse cannot be deemed to fund the trust under the common law unless and to the extent that he provided consideration to or for her other than through funding a trust for her. See Restatement (Second) of Trusts, Section 156, Comment f.; Restatement (Third) of Trusts, Section 58, Comment Illustration 9.

specifically protective of beneficiaries. Many other states provide for some of these exceptions in one manner or the other.

IRAs, Qualified Plans, Insurance, Annuities, 529 Plan Exemptions.

Some states now provide for protection of Section 529 Fund assets, as well as Individual retirement accounts, qualified plans rights, insurance and annuities in certain circumstances. The scope of some of these exemptions is not at all clear. For example, in Arizona, there is no authority whether a disability contract written by an insurance company is an annuity and protected if it is not in pay.

B. RECENT CASES AND OTHER LAW CHANGES.

Bankruptcy 10 Year Look Back Rule for Self-Settled Trusts: 11 U.S.C. Section 548(e).

In 2005, powerful federal pro-creditor legislation was enacted. Bankruptcy Code Section 548(e) became effective, enacted with the Bankruptcy Abuse Prevention and Consumer Protection Act (“BAPCPA”)(Public Law 109-8):

> **11 U.S.C. § 548(e) provides:**
>
> **(1)** In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or **within 10 years** before the date of the filing of the petition, if—
>
> **(A)** such transfer was made to a self-settled trust or similar device;
>
> **(B)** such transfer was by the debtor;
>
> **(C)** the debtor is a beneficiary of such trust or similar device; and
>
> **(D)** the debtor made such transfer with **actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted**.
>
> **(2)** For the purposes of this subsection, a transfer includes a transfer made in anticipation of any money judgment, settlement, civil penalty, equitable order, or criminal fine incurred by, or which the debtor believed would be incurred by—
>
> **(A)** any violation of the securities laws (as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c (a)(47))), any State securities laws, or any regulation or order issued under Federal securities laws or State securities laws; or
>
> **(B)** fraud, deceit, or manipulation in a fiduciary capacity or in connection with the purchase or sale of any security registered under section 12 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78l

> and 78o (d)) or under section 6 of the Securities Act of 1933 (15 U.S.C. 77f).

Most recent cases involving Section 548(e) and asset protection planning noted by commentators have been adverse to debtors. The following are representative.

In re Mortensen.

Battley v. Mortensen, Adv. D.Alaska, No. A09-90036-DMD, May 26, 2011 (Original Memorandum) and July 18, 2011 (Memorandum Denying Motion For Reconsideration). In this nearly famous Alaska bankruptcy case, the debtor creates a trust for his benefit in 2005. The trust instrument states that it is for asset protection purposes. The court found that Debtor was solvent when the trust was funded. He then ran up over $25,000 in credit card debt. In 2009 the debtor filed for bankruptcy. The bankruptcy trustee asserted, among other things, that the transfer to the trust was reachable under 11 U.S.C. § 548(e)(1), the text of which is provided above.

The court ordered trust assets turned over to the bankruptcy trustee:

> "[W]hen property is transferred to a self-settled trust with the intention of protecting it from creditors, and the trust's express purpose is to protect that asset from creditors, both the trust and the transfer manifest the same intent. In this case, I found that the trust's express purpose could provide evidence of fraudulent intent. However, it was not the only evidence upon which I based my decision."

It is interesting that the settlor-debtor's mother gave him the funds that he contributed to his self-settled trust. The transaction could have been structured by her settling a trust for him. Then the assets, in all likelihood, would have been protected from his creditors.

In re Porco, Inc.

This is a plain vanilla bankruptcy court denial of a motion to dismiss regarding when the one year statute of limitations begins running on an alleged concealed transfer. However, there was a second count that the debtor sought to dismiss that resulted in the court interpreting whether a transfer to a single member limited liability company of the debtor could be a "similar device" to a self-settled trust to apply the 10-year look back rule of 11 U.S.C. Section 548(e). The court grant that motion, concluding that the 10 year look back can only be applied only to *express trusts,* and could not be applied to resulting trusts or constructive trusts theories to reach assets in a wholly owned single member LLC. *In re Porco, Inc.,* 447 B.R. 590 (Bkrtcy. DC Ill.

2011). This case was not well pleaded by the parties, leaving the authoritative legacy of this ruling in doubt.

In re Yerushalmi.

Although most cases involving Section 548(e) are favorable to the creditors, there is at least one outlier: *In re Yerushalmi*, 2012 WL 5839938 (E.D.N.Y., slip copy 11/19/2012). A Qualified Personal Residence Trust (a ”QPRT”) was found to be a legitimate structure. The court found that the trust was formed for estate planning purposes and not for a fraudulent purpose. Even though the settlor controlled the trust, it was not his alter ego. The actions were consistent with the QPRT structure. The court stated that even if the debtor said he was the owner, that announcement did not establish that the trust was his “alter ego.” Merely having complete domination of the trust does not make it the controlling party’s alter ego. It is also necessary to show that he used the domination power wrongfully or fraudulently.

Interstate Trust Issues: Choice of Law and Public Policy.

There is much discussion of the use of the law of trust friendly jurisdictions in settling trusts in other states. Some assert the sanctity of the contract clause and full faith and credit guarantees of the U.S. Constitution if declaratory judgments are handed down in the trust friendly jurisdictions. Regardless of the talk, court decisions dealing with these issues are where the rubber meets the road. The creditors do very well in all cases where the settlor, trustee, and beneficiary do not have a real presence in the jurisdiction selected in the trust agreement. Some split hairs over the nuances and theories that the courts follow. Forum state public policy and basic analysis of conflict of laws often are the basis for the court to ignore the trust law selected by the settlor. Jay Adkisson, Esq., a national speaker on cutting edge asset protection cases, has written extensively about recent cases in this area. He wrote at length about *In re* Zukerkorn, 484 BR 182, 192 (9th Cir.BAP, 2012); and *Waldron v. Huber (In re Huber),* 2013 WL 2154218 (Bk.W.D.Wa., Slip Copy, May 17, 2013). *Huber* cites *Zuckerkorn*. The cases are likely templates for the reasoning many courts would use to analyze to apply or reject the protections granted under the trust law of Domestic Asset Protection Trust (“DAPT”) states, such as Alaska (applicable in the Washington case cited) as to whether the DAPT states’ laws violate the public policy in the respective forum states. The courts also throw in a conflict of law analysis. The Court in *Zuckerhorn* looked to the American Law Institute’s Restatement (Second) of Conflict of Laws. Its decision, in quoting from the Restatement is useful:

> (From Restatement (Second) of Conflict of Laws, Introductory Note to Chapter 10):

> The creation of a trust is a method by which the owner of property makes a disposition of it. The chief purpose in making decisions as to the applicable law is to carry out the intention of the creator of the trust in the disposal of the trust property. It is important that his intention, to the extent to which it can be ascertained, should not be defeated, unless this is required by the policy of a state which has such an interest in defeating his intention, as to the particular issue involved, that its local law should be applied . . .
>
> (From Restatement (Second) of Conflict of Laws, Sec. 270, Comment b):
>
> Law designated by the settlor to govern validity of the trust. Effect will be given to a provision in the trust instrument that the validity of the trust shall be governed by the local law of a particular state, provided that this state has a substantial relation to the trust and that the application of its local law does not violate a strong public policy of the state with which as to the matter at issue the trust has its most significant relationship.
>
> A state has a substantial relation to a trust when it is the state, if any, which the settlor designated as that in which the trust is to be administered, or that of the place of business or domicile of the trustee at the time of the creation of the trust, or that of the location of the trust assets at that time, or that of the domicile of the settlor, at that time, or that of the domicile of the beneficiaries. There may be other contacts or groupings of contacts which will likewise suffice.

The *Zuckerhorn* court held for the debtor primarily because the trust was established long ago by a Hawaii resident, and the debtor was just a beneficiary. Since the law in California would also have protected the debtor of such a trust, the Hawaii law did not violate the public policy of California. In analyzing conflict of laws principles, the court found that the law of Hawaii applied to the applicable legal issue because of its greater contacts. *Huber* involved people and property almost entirely situated in Washington. It found that Alaska's self-settled trust law violated the public policy of Washington. In addition it held that, applying conflict of laws principles, Washington had more significant contacts. Restatement (Second) of Conflict of Laws, Sec. 270.

Downside to Being Too Cute.

Sometimes it turns out better if someone just takes his licking, instead of getting proactive. If the court perceives the debtor's shenanigans are too far afield, it can deny a discharge. *In re Portnoy*, 201 B.R. 685 (S.D.N.Y. 1996).

Or if the court thinks it can compel a return of assets but the debtor is just stubborn, it can jail the debtor for contempt. *In re Stephan Jay Lawrence*, 227 B.R. 907 (S.D. Fla. 1998) and *FTC v. Affordable Media, LLC*, 179 F.3d 1228 (9th Cir. 1999).

Lessons.

One of the lessons to take away from this is to consider carefully where any disputes are likely to be resolved. Also consider the type of assets (real or personal property and locations of same), personal and subject matter jurisdiction, and entity creation and operations that own and control the assets at stake. Finally, consider who are the participants and the likely creditors and their location and the choice of law and venue selected in relevant agreements.

C. PLANNING:

Spousal Lifetime Access Trusts (Arizona law is assumed applicable in this discussion and is typical of most states).

This is a popular estate planning technique today. Common acronyms are SLAT or SAT (for spousal access trust). The trust (for this example, assume created under Arizona law, which in many instances is representative of other states) contains provisions similar to the following description. One spouse creates a trust for the benefit of the other (the "beneficiary spouse"). That spouse has a right to distribution for her health, education, maintenance and support ("HEMS right") and has an annual noncumulative ("use it or lose it") 5% right of withdrawal, as well as a special power of appointment. The beneficiary spouse can be the trustee. None of the property contributed to the trust was that of the beneficiary spouse, or that spouse would be contributing to the trust for herself, and to that extent that allocable share would be reachable by her creditors. None of the above described rights and powers will alone cause the trust to be includable in the federal gross estate of the beneficiary spouse. Code Section 2041(a)(2), (b)(1) and (b)(2). Furthermore, the rights are not reachable by the creditors of the spouse. ARS Sections 14-10504(E), 14-10505(B)2. The donor can be reimbursed for his income taxes attributable to the trust, and that right is not reachable by his creditors. ARS Section 14-10505(A)2(a). If the trustee has discretion to to make the reimbursement then such right does not cause the trust to be includable in his gross estate under Code Section 2036(a). Rev. Rul. 2004-64.

Property interests to the extent the spouse beneficiary was an owner, which would include community property, that is to be funded to the trust is not suitable because of the self-settled trust issue. However, the spouse in most states can easily transmute or recharacterize property into the property solely that of the donor spouse. The spouses could just declare that jointly owned property (or community property) is the separate property of the to-be-donor. The problem with the gifting of that property to the trust is that there is a serious risk that the IRS would successfully assert that the step transaction doctrine would apply to treat the gift of the one half community property interest to the one spouse and the separate gift of the newly characterized separate property to the trust is collapse into a transfer of one half of the property by each of the spouses to the trust. Such would cause one half of the balance of the trust at the death of the beneficiary spouse to be included in the gross estate under Code Section 2036. For the same reason, that one half of the trust may be reachable by the creditors of the beneficiary. ARS Section 14-10505(A)(2). Therefore, twice the amount of the jointly owned property should be divided into the separate ownership of each spouse, and the donor gifts only his interest to eliminate the self-settled trust issue.

Once the gift has been made, it is a plain vanilla irrevocable trust, fully effective for gift, estate, and generation-skipping transfer ("GST") tax purposes. The SLAT is generally a grantor trust for income tax purposes, income taxable to the donor spouse. The common technique to assure grantor trust status is for the donor to have the nonfiduciary power to substitute property of equivalent value. Code Section 675(4)(C), Holding such power will not threaten estate tax inclusion of the trust in the donor's estate. Rev. Rul. 2008-22; Rev. Rul. 2011-28. If the spouse is a discretionary income beneficiary, the trust is unavoidably a grantor trust. Code Section 677(a)(1).

Reacquisition of SLAT Interest - Creditor Issue.

Ideally, the donor would like to be able to benefit from the trust at some point. The one sticking point is that under the general rule at common law and under the Uniform Trust Code ("UTC") and most states, the donor remains the settlor and would be unable to protect from his creditors any interest he reacquires in the trust. Model UTC Section 505(a)(2); ARS Section 14-10505(A)(2). There are still possible ways to get around this. One method available at common law is to allow someone the right to withdraw all the assets for some period. This general power of appointment should purge the trust from being treated as settled by the donor spouse and permit asset protection for the interest reacquired by the donor spouse as if he were only a beneficiary and not a settlor. Some states offer more protection.

(Certain State Exceptions.) In Arizona and certain other states, the relevant law may provide important exceptions. ARS Section 14-10505(E) 1, 2, and 3 permit the donor to to become a beneficiary of the trust after the death of the donee spouse, and not be treated as its settlor. Without that section, the creditors of the donor could intercept any distributions that are to be made to him. ARS Section 14-10505(E)(3) provides that the donor spouse is not the settlor if the trust was "for the [beneficiary] spouse," and the donor become a beneficiary after her death. Does being "for the spouse" mean that there can be no other beneficiaries during her life? If the trust was a marital deduction trust for the beneficiary spouse, then there could be no other beneficiaries. Code Section 2056(b)(5) and (7).

There are still many traps for the unwary, even assuming compliance with state statutes that protect donor spouse who become a beneficiary. If the reacquired rights of the donor are limited to the rights of the spouse described in the first paragraph of this section “Spousal Access Trust,” then the creditors of the donors are no better off than the creditors of the beneficiary spouse. If the rights given back to the donor are such that, if held by a nonsettlor beneficiary, are reachable by creditor, then those rights can be taken.

In most states the settlor’s creditor could reach the trust to the extent of the settlor’s resulting interest. In such states, the trust would be includable in the settlor’s gross estate under Code Section 2036(a)(1). Since the settlor’s creditors can reach the assets of the trust to the extent of his interest until his death, he is deemed to retain the right to enjoyment of his property. See *Estate of German v. U.S.*[3]

Reacquisition of SLAT Interest - Estate Tax Issue.

Arizona is one of a handful of states that expressly permit a settlor to reaquire trust interests and not be deemed a settlor. In those states that are not so accommodating, the reacquisition of an interest in the trust automatically will cause the interest to be includable in the gross estate of the settlor, because it is reachable by his creditors. Therefore, to avoid loss of creditor protection, the spouse who created the trust for the other cannot become a beneficiary at any time thereafter. If the creditor of a beneficiary, whether or not the original settlor, can generally reach trust assets, then the trust will be includable in the estate of that beneficiary to the extent of those assets reachable.

Either or both Code Sections 2036 and 2038 can apply to cause some or all of the trust to be includable in the settlor’s estate, even in Arizona. Code Section 2036 applies only if the settlor *retains* an interest in the trust. If the Settlor was not entitled to reacquire the interest upon creation of the trust, then Code Section 2036 does not apply. The trust may be includable in the estate if there was found to be an understanding that, through exercise of a power of appointment or otherwise, the settlor would ultimately receive back an interest. In any event, the trust agreement should not provide that the settlor automatically have a returning interest if federal estate tax is a potential issue.

Code Section 2038 will cause that portion of the trust to be included in the gross estate of the settlor if, at the time of the death of the settlor, the settlor had the power, alone or in conjunction with another, to change the beneficial interests of that portion. In other words, the settlor cannot hold a special power of appointment in the trust at his death if he desires to avoid application of Section 2038 causing inclusion of the trust property in his federal gross estate.

[3] 757 F.2d 1522 (Cl. Ct. 1985).

Best Mode of Donor Spouse SLAT Interest Reacquisition.

If state law is conducive, the trust instrument may permit the beneficiary spouse to appoint the trust in whole or in part in trust for the benefit of the donor settlor, and, in many states, also may permit the donor settlor to be the trustee safely for creditor protection and estate tax purposes even if he is the sole beneficiary during his lifetime. Whether or not the beneficiary spouse has the power to appoint the trust outright to the donor, if she appoints it back but desires that the trust not be in the gross estate of the donor spouse, she should grant the donor no more than a HEMS right, a 5% right of withdrawal, or an income right, or any combination of them. If she desires to avoid the inclusion of the trust in the gross estate of the donor spouse, she should not give the donor a power of appointment, special or general. Even if she did, the donor may be able to make a qualified disclaimer of the undesirable powers. Code Section 2518. If it is not certain that the donor spouse will have a taxable estate, it may be advisable to give the beneficiary spouse the power to give the donor spouse a power of appointment exercisable at his death at that could cause the Delaware Tax Trap to apply to step up basis in trust assets. This is to assure inclusion in his estate to cause step up in basis of trust assets upon his death if it is likely that he will have an estate significantly less than the anticipated exemption, and if there is property in the trust with a value significantly greater that the basis the trust has in the property. Code Section 1014(b)(9). The beneficiary spouse will exercise the power without granting the donor a power of appointment if he is likely to have a taxable estate. She can cherry pick the assets to be includable. Alternatively, she could appoint a trust protector who could grant the power to the donor at any time.

Reciprocal Trust Issue.

The SLAT trust works perfectly well, as described above. But to make things near perfect, it would be great if each spouse could be the beneficiary of their own trust. It seems too good to be true. Partly it is in fact too good to be true. Two hurdles have to be jumped that did not exist with only one SLAT trust in order to accomplish this desired result. One is the issue of whether creditor can reach trust assets under the common law as a result of the mutual actions. The other is whether, for federal estate tax purposes, a spouse will be deemed to be the transferor of the trust of which he or she is the beneficiary, and therefore no estate tax benefit results.

Common Law Reciprocal Trust Doctrine.

Restatement (Third) of Trusts, Section 58 reports that at common law, assets of a trust created by the settlor for his benefit are subject to the claims of his creditors to the extent the trustee is empowered to make distributions to him. If the beneficiary of a trust provided the consideration to induce a person to settle a trust for his benefit, then he will be treated as the settlor of the trust. The following appears in Comment for the section:

> **Illustrations:**
>
> ///
>
> 9. S. transfers $500,000 to T in trust to pay the income to S's brother B for life, remainder to B's issue. At about the same time, pursuant to their prearrangement, B creates a similar trust, also of $500,000, for S and her family. Each trust contains a spendthrift clause. Nevertheless, as settlor of the trust ostensibly created for her by B, she can transfer her interest, and her creditors can reach that interest. (On the tax aspects of this type of "reciprocal trust" arrangement, see Reporter's Notes.) The restraint on alienation is valid, however, with respect to the remainder interests.

Restatement (Second) of Trusts, Section 156, Comment f had previously endorsed the rule:[4]

> f. *Under what circumstances beneficiary is settlor.* In order that a trust shall come within the terms of this Section, it is not necessary that the beneficiary shall have himself conveyed the property held in trust. It is sufficient that he paid the purchase price for a conveyance upon a trust, of which he is the beneficiary or one of the beneficiaries.
>
> **Illustration:**
>
> 2. In consideration of the payment of $10,000 by A to B, B transfers Blackacre to C in trust to pay the rents and profits to A during his life, and to convey Blackacre to D on A's death. At A's request B inserts a provision in the trust deed to the effect that A's interest should not be transferable by him or subject to the claims of his creditors. A can transfer his interest; his creditors can reach his interest.

There is one reported case applying the common law espoused in the restatements. *Security Trust v Sharp,* 77 A.2d 543 (Del. Ct. Ch. 1950). Interestingly, in that case the parties wanted the reciprocal trusts to be uncrossed. By treating the beneficiary as the settlor of her trust, the spendthrift trust provision was invalid. That permitted the beneficiary to assign his interest. The court observed that "it is not

[4] The Second Restatement may be the only relevant Restatement in Arizona for this legal issue. ARS Section 14-10106 provides: Common law of trusts; principles of equity

a. The common law of trusts and principles of equity supplement this chapter, except to the extent modified by this chapter or another statute of this state.

b. The court shall look to the restatement (second) of trusts for interpretation of the common law and not to subsequent restatements of trusts to determine:

1. The rights and powers of creditors of beneficiaries.

2. The duties of trustees to distribute to those to whom a beneficiary owes any duties.

3. Whether public policy may affect enforceability and effectiveness of the terms of the trust.

4. And effectuate the settlor's intent.

unlikely that the same approach would be taken by the courts when such trusts are attacked by creditors."

If this common law reciprocal trust doctrine ("CLRTD") applies, then each spouse is deemed to have settled the trust funded by the other. In such case, creditors of a spouse could reach the trust assets to the extent of the interest of the spouse. ARS Section 14-10505(A)1.

Unique Rule in Arizona.

ARS Section 14-10505(E)4, in its own style, prevents application of the CLRTD:

> E. For the purposes of this section, amounts and property contributed to the following trusts are not deemed to have been contributed by the settlor, and a person who would otherwise be treated as a settlor or a deemed settlor of the following trusts shall not be treated as a settlor:
> ///
> 4. An irrevocable trust for the benefit of a person, the settlor of which is the person's spouse, regardless of whether or when the person was the settlor of an irrevocable trust for the benefit of that spouse.

So, for Arizona law purposes, creditors should not be able to avail themselves of the CLRTD. Spouses should be able to create trusts for one another as asset protection trusts, so long as they do not constitute fraudulent transfers at time of funding.

Estate Tax Reciprocal Trust Doctrine

The federal estate tax is not so easily handled.

a. Definition. The estate tax reciprocal trust doctrine was created in response to trusts drafted with the intention of avoiding the terms of the predecessor to Code Section 2036 (Internal Revenue Code of 1939, Section 811(c)(1)(B)), which provides that certain transferred property in which a decedent retained a life interest was to be included in his gross estate. The reciprocal trust doctrine is applied when two grantors create similar trusts at approximately the same time and there are similar beneficial interests or powers granted by the grantors to one another. The terms of the trust agreements must be sufficiently different to withstand the assertion that Section 2036 applies. The result of application of the doctrine is inclusion of such property in the grantor spouses' respective estates.

b. Case Law and Rulings.

i. U.S. v. Grace, 395 U.S. 316; 23 A.F.T.R.2d 69 (1969). In Grace, the decedent, Joseph Grace, created a trust of which he was a co-trustee and which provided his wife, Janet, with an income interest for life, principal in the discretion of the trustees, and a testamentary power to appoint the trust principal among Joseph and their children. Two weeks later, Janet created a trust for Joseph, naming herself as a trustee and mirroring the terms of the trust that Joseph previously created. The U.S. Supreme Court formulated a two-part test with the following required elements: First, the trusts must be interrelated; and second, the transaction must leave the grantors of the trusts in the same economic position as they would have been in if they had created the trusts naming themselves as life beneficiaries. After applying the test, the court uncrossed the Grace transfers and included in Joseph's gross estate the property that was held in Janet's trust. It is important to note that the there is no need to prove that that trusts were created in consideration of the creation of the other. "Quid pro quo" is not a fact relevant to application of the estate tax reciprocal trust doctrine.

ii. Estate of Levy, T.C. Memo. 1983-453 (1983). In Levy, the decedent and his wife had created trusts for each other on the same day. The trusts were identical, except that the decedent's wife was given a special power of appointment while the decedent was not. The court found that because a power of appointment was created in one trust, but not in the other, the decedent and his wife had substantially different interests in the trusts and, consequently, the trusts were not interrelated for purposes of the reciprocal trust doctrine.

iii. Lehman v. Commissioner, 109 F.2d 99 (2nd Cir. 1940), cert. denied, 310 U.S. 637 (1940). In Lehman, two brothers each created two trusts transferring their one-half share of stocks and bonds to the trusts, giving the other brother income for life, with the remainder to the brother's issue. Each brother had the right to withdraw $75,000 from the other brother's trust. Neither brother executed the right of withdrawal. One brother died and the court held that $150,000 of the other brother's trusts was includable in decedent's estate. The decision was affirmed. If decedent transferred $150,000 to himself for his lifetime in trust, no one would dispute that such amount was includable in his estate. The present case is the same. Each brother transferred the same property in trust to the other brother. The court held that the trusts were "reciprocated" or "crossed," such that the amount subject to withdrawal by decedent from his brother's trust was includable in decedent's estate. The decisive point was that the decedent, by transfer of his share to the brother or for the brother's use or according to the brother's direction, caused the brother to make a transfer of property in trust under which the decedent had the right to withdraw $150,000 from principal, e.g. "quid pro quo."

iv. Estate of Bischoff, 69 TC 32 (1977). Reciprocal Trust Doctrine is applied to uncrossing trusts in which two settlors (spouses) created a trust for their descendants, giving the other a power to alter the beneficial interests. The court found Grace applicable since 2036 applies to retained powers over trust assets under Codes Section 2036(a)(2) to the same extent it applies to retained rights to trust assets under Code Section 2036(a)(1). Code Section 2038(a)(1) also is applicable.

v. PLR 200748016. IRS held that the Reciprocal Trust Doctrine does not apply to uncross trust when siblings are beneficiaries and trustees of trusts settled by their parents. Grace and Bischoff involved settlors with rights and powers in other trusts. Here, the power holders who could benefit one another did not establish or fund the trusts.

c. An example of trust arrangements created that are intended to avoid the Reciprocal Trust Doctrine:

This is an example of trusts that are intended to avoid application of Code Section 2036. The below enumeration describes differences between the Husband's Trust and the Wife's Trust:

1. In the Wife's Trust, the Husband has a special power of appointment from the Marital Trust to any of the Grantor's descendants and charitable organizations. In the Husband's Trust, the Wife does not have a special power of appointment in the Marital Trust.
2. In the Wife's Trust, the Trustee may distribute amounts from the Family Trust for the benefit of the Husband and the Settlors' descendants; whereas in the Husband's Trust, the Trustee may only distribute amounts from the Family Trust to the Wife during her lifetime.
3. In the Wife's Trust, the Husband has a special power of appointment from the Family Trust to any of the Grantor's descendants and charitable organizations. In

the Husband's Trust, the Wife does not have a special power of appointment in the Family Trust.

4. If there are no descendants, then the trust property is distributed to different beneficiaries in the Husband's Trust than in the Wife's Trust.

d. Suggested variances to avoid the Reciprocal Trust Doctrine:

i. Different beneficiaries;
ii. Different trust terms, such as:
    1. Discretionary powers of trustee limited to ascertainable standard (hems power);
    2. Special Power of Appointment for one grantor only;
iii. Created at different times;
iv. Different corpus, or property funding the trusts, and different in amounts;
v. There should be no relation or reference to a prearranged plan; and
vi. Different Trustees.

e. Alternatively, simulate domestic assets protection trust terms (but limited to trusts governed under state laws where the CLRTD will not apply (e.g., Arizona)):

i. require the trustee to be other than the spouses
ii. distribution provision are purely discretionary
iii. follow fact pattern of PLR 200944002 (self-settled Alaska trust ruled not includable in settlor's gross estate)

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