Self-settled spendthrift trusts

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A self-settled spendthrift trust is an irrevocable trust in which the settlor is a beneficiary and the settlor's creditors generally can't reach the trust property. Several states—including Delaware, Nevada, New Hampshire, South Dakota, Tennessee, and Wyoming—recognize self-settled spendthrift trusts.[1] A self-settled spendthrift trust ordinarily has a trustee in such a state, so that it can avail itself of the state's trust laws, including the laws recognizing self-settled spendthrift trusts. Although they are sometimes called asset protection trusts, self-settled spendthrift trusts potentially can play an important role in income and wealth transfer tax planning.

Many states don't recognize self-settled spendthrift trusts. Notably, these states include California, Florida, Massachusetts, and New York. The Uniform Trust Code (UTC) doesn't recognize self-settled spendthrift trusts. The UTC has been adopted by more than 30 states, but some of those states depart from the UTC and recognize self-settled spendthrift trusts. In states that don't recognize self-settled spendthrift trusts, a settlor's creditors typically can reach some or all of the property in an irrevocable trust in which the settlor is a beneficiary. For example, under the UTC, a creditor of the settlor may reach the maximum amount that can be distributed to or for the settlor's benefit.[2]

An individual who resides in a state that doesn't recognize self-settled spendthrift trusts may be able to create one in a state that does, but they may need to consider whether the laws in the state in which they reside could affect the efficacy of a self-settled spendthrift trust or a gift to such a trust. They also may need to consider how the trust is designed and administered. If a self-settled spendthrift trust has substantial connections with a state that doesn't recognize such trusts or the trust is subject to the courts of such a state, that state's laws may apply, and the settlor's creditors may be able to reach some or all of the trust property.[3] If, however, a self-settled spendthrift trust is properly designed and administered (so that it doesn't have substantial connections with a state that doesn't recognize such trusts and it isn't subject to the courts of such a state), the trust property may be protected from settlor's creditors.[4]

When contributing property to a self-settled spendthrift trust, an individual should carefully consider the implications to their solvency and their ability to service their debts and other financial obligations. A transfer to a self-settled spendthrift trust is generally subject to the laws governing fraudulent transfers, and it thus could potentially be invalid if it renders the settlor insolvent or unable to pay their debts as they come due. In some states, the settlor

[1] 12 Del. C. §§ 3570-3576; Nev. Rev. Stat. §§ 166.010-166.170; N.H. RSA 564-B:5-505A; S.D. Cod. Laws §§ 55-16-1 - 55-16-16; Tenn. Code Ann. § 35-16-101; Wyo. Stat. §§ 4-10-502 and 4-10-510 – 523; and Wyo. Stat. §§ 4-10-504 and 4-10-506(c). Several offshore jurisdictions—including Bermuda and the Cayman Islands—also recognize self-settled spendthrift trusts. For an individual who's a US person for income tax purposes, creating and funding an offshore trust raises various tax issues that usually aren't present when creating and funding a US-situs trust. For example, the settlor of an offshore trust may have to recognize any gain in the property transferred to an offshore trust upon the transfer of the property to the trust. IRC § 684(a). In this whitepaper, we'll focus on US-situs trusts that are domestic trusts for US tax purposes.

[2] UTC § 505.

[3] See, e.g., *In re Huber*, 493 B.R. 798 (W.D. Wash, May 17, 2013).

[4] See, e.g., *In re Cleopatra Cameron Gift Trust*, 931 N.W.2d 244 (S.D. 2019) (upholding a spendthrift provision in a third-party settled trust under South Dakota law).

of a self-settled spendthrift trust must provide an affidavit of solvency (or similar document), affirming that the contributions to the trust would not render them insolvent. Some trust companies and other professional trustees require these affidavits as a matter of course. Although an individual might find it appealing to transfer substantial assets to a self-settled spendthrift trust in hopes of protecting more assets from potential creditors, this can be counterproductive. Keeping substantial assets outside of such trusts potentially makes the structure more defensible against claims that transfers of property into those trusts are fraudulent transfers.

Income tax planning with self-settled spendthrift trusts

An incomplete nongrantor (ING) trust is a type of self-settled spendthrift trust, which can facilitate income taxplanning. A contribution to an ING trust is an incomplete gift for federal gift and estate tax purposes, because the settlor retains certain powers to appoint (direct) the distribution of trust property. Accordingly, a contribution to the trust doesn't consume any of the settlor's lifetime exemption (i.e., gift and estate tax exemption).[5] A distribution from an ING trust to a beneficiary other than the settlor ordinarily is a gift for gift tax purposes,[6] and the trust property is includable in the settlor's estate for estate tax purposes upon the settlor's death.[7]

For federal income tax purposes, an ING trust ordinarily is taxable on its capital gains and any undistributed income, and each beneficiary generally is taxable to the extent the beneficiary receives a distribution that includes income for income tax purposes.[8] Since the settlor is a beneficiary, one or more beneficiaries (other than the settlor or the settlor's spouse) must consent to any distributions to the settlor or the settlor's spouse.[9] Otherwise, the trust won't qualify as a nongrantor trust. For this reason, an ING trust usually is designed so that a beneficiary committee (sometimes called a distribution committee or power of appointment committee) must provide such consent.[10]

For state income tax purposes, an ING trust usually is created in a state that, in addition to recognizing self-settled spendthrift trusts, doesn't tax nongrantor trusts. The trust also usually is designed so that it doesn't have any connections with another state that would cause it to be taxable in that other state. If a beneficiary lives in a state that imposes an income tax and the beneficiary receives a distribution from the trust, the beneficiary generally is taxable in thatstate to the extent the distribution includes income for income tax purposes.

For California income tax purposes, however, an ING trust generally is a grantor trust with respect to its settlor.[11] Thus, for California income tax purposes, the settlor generally must report the trust's income,

[5] Treas. Reg. § 25.2511-2(b).
[6] Treas. Reg. § 25.2511-2(f).
[7] IRC §§ 2036(a)(2) and 2038.
[8] IRC §§ 641(a), 652(a), and 662(a).
[9] IRC § 677(a).
[10] See, e.g., PLR 202017018 (April 24, 2020), PLR 202014005 (April 3, 2020), PLR 202007010 (February 14, 2020), PLR 202006006 (February 7, 2020), and PLR 201925005 (June 21, 2019). A private letter ruling isn't precedential guidance. It is issued to a taxpayer in response to the taxpayer's request. The taxpayer who requested the private letter ruling generally can rely on it, but other taxpayers generally can't. A taxpayer, however, can rely on any private letter ruling issued after October 31, 1976, for purposes of determining whether there's substantial authority
[11] Cal. Rev. and Tax. Code § 17082(a).

deductions, and credits on their personal income tax return.[12] Similarly, for New York income tax purposes, an ING trust is a grantor trust with respect to its settlor if the settlor was a New York resident when the trust was funded.[13] Thus, for New York income tax purposes, the settlor must report the trust's income, deductions, and credits on their personal income tax return.[14]

In addition to its potential asset protection benefits, an ING trust offers some interesting income tax planning opportunities. An ING trust can potentially avoid state income tax on the capital gains and other income from its assets (such as shares of a corporation). For example, a business owner might create an ING trust and contribute vested shares of a corporation to the trust. When the trust later sells those shares, the gain potentially would avoid income tax in the state in which the business owner lives. The business owner must live in a state that, for state income tax purposes, classifies the trust as a nongrantor trust (consistent with its classification for federal income tax purposes). The business owner must contribute the shares to the trust before the gains become includable in their income for income tax purposes. In the case of shares of a privately held company, that's usually before the signing of a binding agreement to sell those shares (and even earlier may be better). The gain mustn't be income that's sourced to a state that has an income tax. Source income is generally taxable in the state to which it's sourced (i.e., from where it's treated as arising). In some states, gain from the sale or exchange of a pass-through entity (such as an S corporation, a partnership, or a limited liability company that's classified as a partnership for tax purposes) is sourced to the state in which the entity conducts its business activities. The trust generally can't have any trustee (or possibly other fiduciary) in the state in which the business owner lives.

An ING trust also can potentially enable a shareholder to stack (multiply) exclusions of gain upon the sale or disposition of qualified small business (QSB) stock. The shareholder could create an ING trust and contribute shares to the trust. The trust may qualify for its own exclusion upon its sale or disposition of the stock. If a shareholder who qualifies to exclude up to $10 million of gain upon the sale or exchange of shares of QSB stock gifts some of those shares to an ING trust, the trust also can potentially exclude up to $10 million of gain upon its sale or exchange of the shares it holds. If a shareholder uses multiple trusts for purposes of stacking, the trusts should have different primary beneficiaries. If two or more trusts have substantially the same settlors and primary beneficiaries and a principal purpose for establishing or funding the trusts is the avoidance of federal income tax, then they may be treated as a single trust for income tax purposes.[15]

[12] Id.
[13] NY Tax Law § 612(b)(41).
[14] Id.
[15] Treas. Reg. § 1.643(f)-1(a).

For a more in-depth discussion of planning strategies involving ING trusts, see Ann Bjerke and Todd D. Mayo, *ING Trusts* (a publication of the UBS Advanced Planning Group), and Todd D. Mayo, *ING Trusts: Key Decision Points for Settlors* (a publication of the UBS Advanced Planning Group). For a more in-depth discussion of QSB stock and stacking, see Todd D. Mayo, *Qualified Small Business Stock* (a publication of the UBS Advanced Planning Group).

Wealth transfer tax planning with self-settled spendthrift trusts

A settlor potentially can design a self-settled spendthrift trust so that contributions to the trust are a completed gift for gift tax purposes and the trust property isn't includable in their estate for estate tax purposes. This isn't possible with a trust subject to the laws of a state that doesn't recognize self-settled spendthrift trusts. Since those laws would enable the settlor's creditors to reach some or all of the trust property in a trust of which the settlor is a beneficiary, the trust property would be includable in the settlor's estate for estate tax purposes.[16]

In a 2009 ruling, the Internal Revenue Service (IRS) concluded that merely being a beneficiary (and thus eligible to receive distributions) wouldn't cause the trust property to be includable in the settlor's estate for estate tax purposes).[17] The IRS didn't rule on whether it might be includible for other reasons.[18] Since the settlor of a self-settled spendthrift trust is a beneficiary to the trust, the trustee can make distributions to the settlor. The settlor just can't be entitled to receive distributions and can't have certain other rights and interests, like the right to revoke the trust and take back the trust property. And there can't be any understanding or pre-existing arrangement between settlor and the trustee concerning the trustee making distributions to the settlor.[19] A pattern of distributions to the settlor may imply such an understanding exists.

Using a completed gift, self-settled spendthrift trust, an individual can make a gift that consumes some or all of the individual's lifetime exemption, creating a pool of assets that are outside of their estate for estate tax purposes while being eligible to receive distributions from the trust. From a wealth transfer tax perspective, the individual ideally wouldn't seek to receive any distributions from the trust, because those distributions would be tax inefficient. If, however, the individual suffers a financial reversal, any potential wealth transfer tax savings may become unimportant, and being eligible to receive distributions from the trust may provide a valuable safety net.

Instead of a self-settled spendthrift trust, a married individual whose marriage is stable might consider a spousal lifetime access trust (sometimes called a "SLAT"), which is an irrevocable trust in which the settlor's spouse is a beneficiary. Since the settlor's spouse is a beneficiary,

[16] Paolozzi v. *Commissioner*, 23 T.C. 182 (1954), acq., 1962-2 C.B. 5; and *Outwin v. Commissioner,* 76 T.C. 153 (1981).
[17] PLR 200944002 (October 30, 2009).
[18] Id.
[19] *Estate of Paxton v. Commissioner,* 86 TC 785 (1986). See TAM 199917001 (May 3, 1999).

there is the potential for the couple to benefit from the trust assets. These trusts are common and generally can be created under the laws of any state. Although there are some important tax considerations intheir design and administration, the tax laws affecting spousal lifetime access trusts are generally more well-established than those affecting self-settled trusts.

A married individual whose marriage is stable might consider a spousal lifetime access trust in which the trustee or trust protector can add the settlor as a beneficiary or a spousal lifetime access trust in which the settlor's spouse can appoint trust property to the settlor (either during life, upon death, or both and either outright or in trust). These variations on the spousal lifetime access trust can provide more flexibility. Since these variations involve the settlor potentially benefiting from the trust property, they generally should be created in a state that recognizes self-settled spendthrift trusts, and they should be designed and administered with the same thought and care as self-settled spendthrift trusts. Notably, the same tax considerations that apply to a self-settled spendthrift trust in which the settlor is a current beneficiary generally apply to a spousal lifetime access trust in which the settlor can be added as a beneficiary or from which trust property could be appointed to the settlor.

For a more in-depth discussion ofthese trusts, see Catherine McDermott, *Spousal Lifetime Access Trusts* (a publication of the UBS Advanced Planning Group).

Conclusion

For some individuals, self-settled spendthrift trusts may play valuable role in their wealth structure. A self-settled spendthrift trust potentially can hold a pool of assets from which the settlor may be able tobenefit, while generally insulating those assets from the settlor's creditors and possibly facilitating income and wealth transfer tax planning.

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