Almost Everything You Want to Know About Saving for College

By Michael S. Singer and Lisa Z. Hauser

A question frequently asked by clients is, "What is the best way to save or pay for education, especially college education for my children and grandchildren?" While there may not be one best solution for every situation, more options are available to pay for education today than ever before. This article examines the most frequently used methods to pay for college and other related educational expenses by undertaking an analysis of the . . .

- Tax consequences
- Asset protection issues
- Other practical issues raised in utilizing various funding scenarios

Gift Tax Exclusions

Several gift tax exclusions that may apply to clients who wish to fund the college education of family members are discussed in the following subsections.

The Annual Exclusion

Previously, the federal estate and gift tax law permitted a person to give any other person up to $10,000 per year free of federal gift tax (the annual exclusion). As of January 1, 2002, the annual exclusion amount is $11,000 per donee [Rev. Proc. 2001-59, 2001-52 I.R.B. 623]. State gift tax procedures vary from state to state.

Thus, between a married couple, up to $22,000 per year can be given to a beneficiary without incurring any gift tax consequence. Gifts made in excess of the annual exclusion from the gift tax will reduce the donor's $1 million "applicable credit amount"; thus, no gift tax is actually paid to the IRS until the donor's $1 million applicable credit amount has been exhausted [IRC § 2505(a)(1); all references hereunder to "IRC" are to the Internal Revenue Code of 1986, as amended, unless otherwise specified]. It is widely established that payments of college expenses by a parent are in the nature of support and are not subject to the imposition of a federal gift tax.

Unlimited Exclusion for Tuition Payments

Payments of qualified medical expenses and educational expenses are not subject to the federal gift tax or generation-skipping transfer (GST) tax and do not count against the annual exclusion [IRC § 2503(e), § 2642(c)(1) and (c)(3)(B)]. The educational expense exclusion is limited to payments for tuition made directly to the educational institution [IRC § 2503(e)(2)(A)]. Thus, one of the most straightforward and simple tax-free methods of paying for higher education is to simply write a check directly to the college for tuition.

Often practitioners advocate payment of a grandchild's higher education by grandparents to reduce the grandparent's taxable estate for federal estate tax purposes. Such payments by grandparents also escape being subject to the GST tax [IRC § 2642(c)(3)]. Direct payment of higher education expenses is probably the most straightforward mechanism to pay for education; however, that strategy requires the donor to be alive at the time of the transfer. While grandparents are alive, direct educational gifts are very effective. However, that technique is limited to lifetime gifts.

The IRS has ruled in recent years that prepaid tuition payments made by a grandparent on behalf of grandchildren directly to the educational institution qualify for the unlimited gift tax exclusion under IRC § 2503(e) [Tech. Adv. Mem. 199941013 (Oct. 18, 1999)]. Under the facts of the ruling, a grandparent made a series of tuition payments to a private school for her grandchildren's tuition payments for 1994 through 2004. The payments were completed by 1996. The payments were not refundable, and the grandparent and the school entered into written agreements, which provided that the payments were to be applied in payment of tuition for the grandchildren for specified years. The IRS distinguished those from educational payments made directly to a school from a trust established by a grandparent for a grandchild, which does not qualify for the unlimited gift tax exclusion under IRC § 2503(e) [see Treas. Reg. § 25.2503-6(c) *Example 2* (1984)].

Because the grandchildren never have control over funds paid directly to an educational institution, no asset protection concerns exist for the donee. To the extent that payment is made by a potential debtor, the only asset protection concern would be if the gift were made as a preference in bankruptcy or in deference of a known or actual (or technically future) creditor under various state fraudulent transfer and asset conversion laws.

Custodial Accounts

The second method, and until now, perhaps the most frequently used, was the establishment of accounts for children and grandchildren under the Uniform Gifts to Minors Act or Uniform Transfers to Minors Act. These accounts, known as UGMA or UTMA accounts (hereinafter referred to collectively as UTMA accounts), contemplated that a gift would be made from parents or grandparents in an amount up to the annual exclusion. The transfer would be a completed gift of a present interest for transfer tax purposes, meaning that the donor parted with control of the gift in favor of the donee, and would qualify for the annual exclusion [Rev. Rul. 59-357, 1959-2 C.B. 212; see Treas. Reg. § 25.2503-3(b) (as amended in 1983)

defining the term "present interest in property"].

If the transfer to the UTMA account qualifies for the annual exclusion, the transfer will also be exempt from the GST tax [IRC § 2642(c)(1) and (c)(3)(A)]. With sound investment in UTMA accounts from a very young age, the value of such accounts could grow substantially and generate significant value.

Income Tax Treatment

From an income tax perspective, the income of the UTMA account is taxed currently on its current income tax attributes. The investment income earned on an UTMA account (i.e., taxable interest and dividend income) is considered the unearned income of the minor child, regardless of whether such income is distributed to the child [Treas. Reg. § 1.1(i)-1T, Q&A 15 (1987), and IRS Publication 929 (2001); see also IRC § 1(g)(4)(A) and § 911(d)(2)].

To illustrate, a minor child must file a return for tax year 2001 if all of his or her income is unearned income and the total amount of income exceeds $750 [IRS Publication 929 (2001)]. If the minor child is blind, that amount increases to $1,850 for 2001. Different minimum amount rules apply if the minor child has both earned income (i.e., wages) and unearned income [Treas. Reg. § 1.1(i)-1T, Q&A 15 (1987), and IRS Publication 929 (2001); see also IRC § 1(g)(4)(A) and § 911(d)(2)].

Generally, the child is responsible for filing his or her own tax return and paying any tax, penalties, or interest due thereon [IRS Publication 929 (2001); see also Treas. Reg. § 1.1(i)-1T, Q&A 15 (1987), and IRC § 1(g)(4)(A) and § 911(d)(2)]. If a child cannot file for any reason, the child's parent or guardian is responsible for filing a return on the child's behalf [IRS Publication 929 (2001); see also Treas. Reg. § 1.1(i)-1T, Q&A 15 (1987), and IRC § 1(g)(4)(A) and § 911(d)(2)].

Special rules apply to the investment income of a child under the age of 14 [IRC § 1(g)]. If the investment income totals more than $1,500 (for tax year 2001), part of such income may be taxed at the parent's tax rate instead of the child's tax rate [IRC § 1(g)(1)]. Alternatively, the parent may elect to include the child's investment income from the UTMA account on the parent's return rather than file a separate return for the child [IRC § 1(g)(7)].

A different income tax issue may arise to the extent that the investment income from an UTMA account is used to support the minor. If that occurs, the person who has the legal obligation to support the minor is subject to income tax on such income [Rev. Rul. 59-357, 1959-2 C.B. 212].

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Estate Tax Treatment

From an estate tax perspective, the value of the UTMA account is includible in the gross estate of the donor if...

1. The property is given in contemplation of death within three years of the donor's death, or

2. The donor appoints himself or herself custodian and dies while serving in that capacity [Rev. Rul. 59-357, 1959-2 C.B. 212].

In all other circumstances, the assets of the UTMA account are includible in the gross estate of the minor donee.

Asset Protection Issues

From an asset protection standpoint, there have been a few cases in which creditors have attempted to argue that the UTMA accounts should be available to the donor's creditors. Most of these cases are actually divorce cases in which a spouse has argued that the creation or funding of an UTMA account should be set aside as a preferential predivorce transfer [see, e.g., *DeMarco v. DeMarco,* 1999 Conn. Super. LEXIS 2179 (Conn. Super. Ct. Aug. 10, 1999); *Perlberger v. Perlberger,* 626 A.2d 1186 (Pa. 1993); and *In re the Marriage of Beth and Roy E. Stephenson,* 162 Cal. App. 3d 1057 (1984)]. When a gift is made in the non-UTMA context, generally in a divorce or fraudulent transfer action, the donor must prove that . . .

- He or she had donative intent when the gift was made, and
- Actual delivery of the gift had occurred [*Stephenson* at 1068-1069].

Under the Uniform Transfers to Minors Act, the second requirement is generally presumed. For example, see Florida's version of the Uniform Transfers to Minors Act [Fla. Stat. §§ 710.109 and 710.111 (2001).All references to Florida statutes hereunder are to the 2001 statutes unless otherwise specified]. Although in many cases the creditor (or often the ex-spouse) has asserted that there was no donative intent, the majority of the cases have held that merely opening an account designated as an UTMA account assumes donative intent because the transfer to the account is irrevocable [see *Stephenson* at 1069 and *Gordon v. Gordon,* 419 N.Y.S. 2d 684 (N.Y. App. Div. 1979)].

Once the UTMA account is distributed to the child, however, the child has no independent asset protection available to him or her. For example, if the child is liable in an automobile accident in an amount in excess of his or her automobile liability insurance limits, the distributed UTMA proceeds are considered fair game.

Beneficiary's Right to Funds

The greatest concern about UTMA accounts is from neither a tax nor purely an asset protection perspective. Under the Uniform Trust for Minors Act, a child has the absolute right at the age of majority to remove all of the funds from the UTMA account.

Unfortunately, some parents have discovered or are now discovering that their children, away from home, are

getting a very practical hands-on education from their peers. The children can simply inquire about the existence of the UTMA accounts at their parents' banking or other financial institution and request distribution of the amounts. Suffice to say, when the parents learn of their child's instruction to the bank to transfer a fund with a six-figure balance to the child's college checking account, such parents may have more than a few anxious moments.

While parents often use leverage such as threatening to cut off children for exercising that right, the child's right to the UTMA account is absolute. As such, many practitioners have actively advised clients against accumulating substantial funds in an UTMA account.

Clients often ask, "What do I do if I have substantial funds in UTMA accounts?" Fortunately, in that regard there are some solutions. The Florida Uniform Transfers to Minors Act, for example, states that funds in an UTMA account may be used for the minor's benefit without court order and without regard to the duty or ability of the custodian personally or of any other person to support the minor [Fla. Stat. § 710.116, but see Rev. Rul. 59-357, 1959-2 C.B. 212 and the discussion above].

Further, the custodian has all of the rights and powers over the property for which he or she is custodian that he or she would have if he or she were unmarried and exercising control over the property [Fla. Stat. § 710.115]. The custodian must, however, follow the standards of care of a fiduciary under the Uniform Transfers to Minors Act [Fla. Stat. § 710.116].

As such, it is often advisable to spend down UTMA funds for the minor's benefit and replace them with funds that are less attractive to the potential misuse of a misguided child. In fact, under the guidance of the Uniform Transfers to Minors Act, funds can be spent on children's current education without violating any of the fiduciary duties set forth under that Act. Furthermore, a fiduciary is generally able to transfer UTMA funds to a Section 529 plan (such Section 529 plans will be discussed in detail in the July issue of *Estate Tax Planning Advisor*), although some states' plans require the UTMA funds to be segregated and separately accounted for within the Section 529 plan. In sum, the use of UTMA accounts as a planning tool in the 21st century appears to be obsolescent.

Education Trusts

Because of the problem with child-proofing UTMA accounts, many clients elect to fund education via various types of trusts. Parents, grandparents, or other relatives may wish to establish an irrevocable trust, the funds of which are limited to use for the beneficiary's education. Establishing a trust can free the donor of the main worry of an UTMA account because the donor controls all distributions and/or withdrawals from the trust. The trust agreement can provide whatever terms and conditions the donor desires for when the beneficiary can withdraw the trust funds for a reason other than educational expenses. Thus, when the beneficiary attains the age of majority, he or she cannot merely instruct the trustee to distribute the remaining funds outright to him or her.

Gift Tax Treatment

The transfers of funds to an irrevocable trust are taxable gifts to the beneficiaries of such trust. These gifts can be made tax-free by having them qualify for the annual exclusion. In order to obtain tax-free treatment, the beneficiaries must enjoy the right to withdraw the gifted amounts from the trust (i.e., have a present interest in the gifted amounts). That right to withdraw (known as a *Crummey* withdrawal right) usually exists for a limited period of time from the date gifts are made to the trust; the trustee sends *Crummey* notices to the beneficiaries of the transfer [*Crummey v. Com'r*, 22 AFTR 2d 6023 (9th Cir. 1968), and *Cristofani v. Com'r*, 97 T.C. 74 (1991)].

Once a beneficiary declines to withdraw property transferred to the trust or lets the limited period of time lapse, the gift qualifies as a tax-free annual exclusion transfer. Thus, parents and other relatives can make annual transfers of $11,000 ($22,000 for a married couple) per beneficiary to the trust without having any federal gift tax consequences if the *Crummey* notice requirements are met.

Hope and Lifetime Learning Credits

By Michael S. Singer and Lisa Z. Hauser

Although they are not savings strategies, the Hope and Lifetime Learning Credits [IRC § 25A] may be of interest to clients. A client is entitled to a Hope Scholarship Credit up to $1,500 a year per student (who is attending school on at least a half-time basis) for the first two years of college. The credit is a 100 percent credit for the first $1,000 of tuition and a 50 percent credit for the second $1,000 of tuition [IRC § 25A(b)(1)].

Alternatively, a client can take a Lifetime Learning Credit up to $1,000 per family for every additional year of college or graduate school. The credit is 20 percent of qualified tuition and related expenses that do not exceed $5,000 [IRC § 25A(c)(1)]. The $5,000 expense limitation will be increased to $10,000 as of January 1, 2003, thus increasing the credit to a maximum of $2,000. The Lifetime Learning Credit is not available with respect to qualified tuition and related expenses paid in connection with an individual for whom a Hope Scholarship Credit is allowable [IRC § 25A(c)(2)(A)].

The amount of qualified tuition and related expenses taken into account in determining the availability of a credit is required to be reduced by any part of a distribution from a Coverdell education savings account (CESA) [IRC § 25A(g)(2)(C)]. Both credits begin to be phased out for individuals with a modified adjusted gross income of $40,000 ($80,000 for a couple) [IRC § 25A(d)(2)]. ■

Estate Tax Treatment

The donor of the property runs no risk of having the trust property included in his or her gross estate for estate tax purposes upon the donor's death. That treatment presumes the trust agreement does not include any provisions that would otherwise trigger inclusion in the donor's gross estate for estate tax purposes.

Upon a beneficiary's death, to the extent a *Crummey* withdrawal right remains, a portion of the trust assets may be included in the beneficiary's gross estate for estate tax purposes [IRC § 2041]. In addition, other trust provisions may trigger inclusion of trust assets in the beneficiary's gross estate for estate tax purposes.

GST Tax Treatment

Clients should be aware that the GST tax applies to nontaxable transfers made to *Crummey* trusts unless the trust agreement contains certain provisions, i.e., the trust must provide that...

1. During the life of the individual beneficiary, no portion of the corpus or income of the trust may be distributed to or for the benefit of any person other than the beneficiary, and

2. If the trust does not terminate before the individual beneficiary dies, the assets of such trust must be includible in the estate of the beneficiary [IRC § 2642(c)(2)].

That issue can be resolved by the donor's allocating a portion of his or her GST exemption (currently $1.1 million) to the transfer. The allocation can be made on a timely filed gift tax return.

Section 2503(c) Trusts

An alternative type of trust can be established for the benefit of children under the age of 21. No part of a gift to a Section 2503(c) trust will be considered a gift of a future interest if certain requirements are met [IRC § 2503(c)].

The terms of Section 2503(c) are written in the negative. Generally, if the requirements are met, the property transferred to the Section 2503(c) trust will qualify for the annual exclusion without the need for *Crummey* withdrawal provisions. Similar to UTMA accounts, Section 2503(c) trusts must require that the property and income remaining in the trust must pass to the beneficiary when the beneficiary attains age 21 [IRC § 2503(c)(2)]. Alternatively, if the beneficiary dies prior to attaining age 21, the remaining trust assets must pass to the beneficiary's estate or be subject to the beneficiary's general power of appointment [IRC § 2503(c)].

Here are some additional issues to consider:

• **Gift, estate, and GST tax treatment.** The trust must require that the trust property and its income be expended by or for the beneficiary before the beneficiary attains age 21 [IRC § 2503(c)(1)]. However, the IRS has ruled that a gift of trust income only to a minor via a Section 2503(c) trust meets the requirements of the statute for purposes of qualifying for the annual exclusion even though the beneficiary has no interest in the trust corpus [Rev. Rul. 68-670, 1968-2 C.B. 413; see *Com'r v. Thebaut*, 17 AFTR 2d 1443 (5th Cir. 1966), and *Herr v. Com'r*, 9 AFTR 2d 1963 (3d Cir. 1962)].

The assets of the Section 2503(c) trust escape inclusion in the donor's gross estate but will be subject to the estate tax in the donee's gross estate. The GST tax does not apply to transfers to a Section 2503(c) trust [IRC § 2642(c)(1) and (c)(3)(A); Section 2503(c) transfers qualify for the annual exclusion under Section 2503(b)]. Because of the mandatory distribution requirement at age 21, clients do not usually favor establishing Section 2503(c) trusts.

• **Income tax treatment.** From an income tax perspective, clients should be made aware that a trust will be taxed at the highest income tax rate (currently 39.6 percent) after earning a mere $7,500 of income. That issue can be resolved to a certain extent if the trust is established as a grantor trust [see IRC §§ 671 through 679]. Although irrevocable grantor trusts are not usually established for education purposes, if the trust is established as a grantor trust, any income earned by the trust will be taxed to the donor of the trust and thus reported on the donor's income tax return.

• **Asset protection issues.** From the asset protection perspective, the Section 2503(c) trust method is probably the safest of all the methods discussed in this article. If the trust is irrevocable and properly drafted, under most state and federal bankruptcy laws, the trust is a spendthrift trust in the child's hands, and thus unalienable to the child's creditors. Therefore, the trust funds are untouchable by the child's creditors until the money is actually given to the child. If the child has creditor issues, obviously the trustee would be well advised to make expenditures on behalf of the child rather than distribute significant money directly to the child, provided that the trust instrument has been properly drafted.

As to the donor, except for a transfer made to avoid creditors (where a creditor exists), the funds appear to have no real exposure to the donor's creditors as the donor parts with all control (if the trust is irrevocable) of the funds upon making the gift to the trust.

Education IRA and Education Credits

Before discussing the fourth, and probably most exciting, method of funding education that has been available to date, we should acknowledge that there is another educational funding tool as well as two types of education tax credits (see "Hope and Lifetime Learning Credits" on page 9).

Coverdell Education Savings Accounts

Previously known as an education IRA, a Coverdell education savings account (CESA) enables a client to make contributions up to $2,000 a year (in 2002) for each child under the age of 18 [IRC § 530]. The age limitation does not apply to a "special needs" beneficiary [IRC § 530(b)(1)]. Contributions to a CESA must be made in cash.

A donor's right to make contributions to a CESA begins to phase out once the individual's modified

adjusted gross income is over $95,000 ($190,000 for joint filers) [IRC § 530(c)]. If the income limitation is a problem, consider having the child make contributions to his or her own CESA.

Contributions to a CESA are not tax deductible. However, earnings in the account are exempt from taxation, subject to the unrelated business income rules [IRC § 530(a)], and distributions are tax-free if spent on qualified education expenses [IRC § 530(d)(2); qualified education expenses are defined in IRC § 530(b)(2)]. Subject to certain exceptions, to the extent CESA funds are used for noneducational reasons, such funds will be subject to income tax and a 10 percent penalty [IRC § 530(d)(4)]. Exceptions include distributions made on account of a scholarship received by the beneficiary and distributions attributable to the beneficiary's being disabled.

Any balance in the CESA must be distributed to the beneficiary within 30 days of the beneficiary's attaining the age of 30 [IRC § 530(b)(1)(E)]. Alternatively, unused CESA funds can be rolled over tax-free to another CESA for another member of the beneficiary's family who has not yet attained age 30 [IRC § 530(d)(5)].

Section 529 Plans

The final method of funding for education was created by the Small Business Job Protection Act of 1996, which provided for college savings plans under Section 529 of the Internal Revenue Code. Section 529 plans are the focus of an article by the same authors, which will be published in the next issue of *Estate Tax Planning Advisor.*

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or future, or whether the creditors are reasonably anticipated or impossible to foresee. An intent to defraud creditors is not required for the application of that rule [see, e.g., 5A Aston W. Scott & William F. Fratcher, *The Law of Trusts* § 156, at 165-167 (4th ed. 1989); see also, *Restatement (Second) of Trusts* § 156, cmt. a (1959)].

The authors (among others) have challenged the proposition that public policy should per se preclude the recognition of self-settled spendthrift trusts [see Rothschild, Rubin, and Blattmachr, "Self-Settled Spendthrift Trusts: Should a Few Bad Apples Spoil the Bunch?" 32 *Vand. J. Transnat'l L.* 763 (1999)]. It remains the case in most (though by no means all) jurisdictions, however, that self-settled spendthrift trusts will not be recognized as effective against the settlor's own creditors.

Trust Situs

The settlor of a trust may designate the law of any jurisdiction as governing the trust's administration, not just that of his or her own domicile. As a result, the settlor may designate a jurisdiction that recognizes self-settled spendthrift trusts as valid even though the jurisdiction of the settlor's domicile does not do so. Under established conflict-of-law rules, "[w]hether the interest of a beneficiary of [an *inter vivos*] trust of movables is assignable by him and can be reached by his creditors is determined . . . by the local law of the state, if any, in which the settlor has manifested an intention that the trust is to be administered . . ." [see, e.g., *Restatement (Second) Conflict of Laws* § 273 (1971); see also, "Convention on the Law Applicable to Trusts and on Their Recognition," Oct. 8, 1984, art. 6 reprinted in 23 *I.L.M.* 1389, 1389 (1984) ("A trust shall be governed by the law chosen by the settlor.")].

A settlor domiciled in one state may create an *inter vivos* trust by conveying property to a trust company located in another state as trustee. The settlor would deliver the property to the trust company to be administered in a state in which the trust company is located. The law of the state in which the trust company is located applies as to the rights of creditors to reach the beneficiary's interest.

That shift in jurisdiction permits a person who is domiciled in a state that does not permit restraints on alienation to create an *inter vivos* trust in another state where restraints on alienation are permitted. Such a settlor can take advantage of the law of the state in which the trust is located [5A Aston W. Scott and William F. Fratcher, *The Law of Trusts* § 626, at 419 (4th ed. 1989)]. More specifically, the policy of one jurisdiction relating to spendthrift trust protections is not thought to be so strong as to preclude the application of the law to the contrary prevailing in another jurisdiction [5A *The Law of Trusts* § 626 at 414;. see, e.g., *Surman v. Fitzgerald (In re Fitzgerald)*, 1 Ch. 573 (1904), *rev'g* 1 Ch. 933 (1903); see also, "Self-Settled Spendthrift Trusts: Should a Few Bad Apples Spoil the Bunch?"].

Several courts use public policy considerations to justify the application of the forum's laws. The authors suggest, however, that such result-oriented applications were dictated by the egregious facts present in such cases.

Only a minority of jurisdictions, both onshore and offshore, permit the establishment of effective self-settled spendthrift trusts. Self-settled spendthrift trusts are available, however, to all persons regardless of domicile in much the same way as the benefits of Delaware corporate law are available regardless of the domicile of the corporation's organizers, shareholders, officers, and directors. Care must be taken, however, in order to achieve all of the desired benefits of an effective self-settled spendthrift trust. This article focuses on some of the considerations that the estate planner must work through in establishing an effective self-settled spendthrift trust for his or her clients.

Choice of Law

The primary consideration in establishing an effective self-settled spendthrift trust is the law under which the

trust is established. In that regard, the practitioner has the choice of a fair (and constantly expanding) number of offshore jurisdictions, including . . .

- Anguilla
- Antigua
- The Bahamas
- Barbados
- Belize
- Bermuda
- The Cayman Islands
- The Cook Islands
- Cyprus
- Gibraltar
- Labuan
- The Marshall Islands
- Mauritius
- Nevis
- Niue
- St. Vincent and the Grenadines
- Seychelles
- The Turks and Caicos Islands

Moreover, in recent years, a small number of onshore jurisdictions have enacted specific legislation in order to garner for themselves domestic capital that would otherwise be diverted offshore for asset protection purposes. To date, those onshore jurisdictions include . . .

- Alaska
- Delaware
- Nevada
- Rhode Island

Similar legislation has been proposed in at least two additional states [see, e.g., H.R. 1553, 76th Leg. (TX) (introduced Feb. 17, 1999), available in Westlaw, TX-BILLS Database, and New York State Assembly Bill 09053 (introduced August 5, 1999), available in Westlaw, NY-BILLS Database].

Among those jurisdictional choices, three aspects of the governing law are key:

1. The breadth of the jurisdiction's fraudulent conveyance law

2. The existence (or absence) of an express nonrecognition of foreign judgments within the jurisdiction's body of law

3. The existence (or absence) of an express recognition of the validity of self-settled trusts against the settlor's creditors.

A foreign asset protection trust can, with careful forethought, be drafted so as to impart significant asset protection while at the same time being totally income and transfer tax neutral for U.S. tax purposes.

Fraudulent Conveyance

With regard to the first point, the fraudulent conveyance law that most common-law jurisdictions follow proceeds directly or indirectly from the English Statute of Elizabeth of 1571. That statute provides, without any inherent limitations period, that any transfer made with the ". . . intent to delay, hinder or defraud creditors . . . shall be clearly and utterly void . . ." Any jurisdiction that has not modified that draconian edict would make a poor choice for asset protection planning, since there can never be any certainty that a transfer to an otherwise valid trust would not ultimately be rendered void through a claim, made years or even decades after the fact, that the funding of the trust was made with an intent to delay, hinder, or defraud creditors.

Certain jurisdictions, such as Belize, have repealed the Statute of Elizabeth without having enacted other fraudulent conveyance law. Nevertheless, it is unlikely that other jurisdictions will respect such a state of affairs [see, e.g., *Brown v. Higashi (In re Brown)*, No. 95-3072 (Bankr. D. Alaska, Mar. 12, 1996)]. Clearly, some limitations period is appropriate as part of a fair balancing between the legitimate interests of debtors and creditors.

In addition, consideration should be given to whether it is the creditor or the debtor that bears the burden of proving (or disproving) that a fraudulent conveyance has occurred, as well as the standard of proof that is required. In Nevis, for example, the creditor bears the burden of proving, beyond a reasonable doubt, that the trust's funding was a fraudulent conveyance (and then, as to *that* particular creditor) [Nevis International Exempt Trust Ordinance, 1994, § 24(1)]. By contrast, in most other jurisdictions, the standard of proof requires a mere preponderance of the evidence.

Nonrecognition of Foreign Judgments

Seeking a jurisdiction that will not recognize a foreign judgment can become important in the selection process. An express nonrecognition of foreign judgments under the governing jurisdiction's law is an important consideration in choosing among those jurisdictions that recognize the validity of self-settled spendthrift trusts. Notwithstanding the legal precepts set forth above, those few cases that have considered the conflict-of-law issue in a forum whose own law deems such trusts void as against public policy have frequently applied such law in disregard of the settlor's designation of governing law [see, e.g., *Sattin v. Brooks* (*In re Brooks*), 217 B.R. 98 (Bankr. D. Conn. 1998); *Marine Midland Bank v. Portnoy* (*In re Portnoy*), 201 B.R. 685 (Bankr. S.D.N.Y. 1996)].

Those holdings arose under the most egregious factual circumstances imaginable, including allegations of fraud, perjury, and bankruptcy crime on the part of the settlor. Nevertheless, those holdings are strongly suggestive of the likelihood that most domestic courts suffer from strong prejudices against applying a legal principle that conflicts with that of the forum.

Where the trust's assets are situated outside of the forum jurisdiction, how-

ever, and the jurisdiction of the governing law does not recognize foreign judgments, the determination of the forum court to disregard settled law based upon its own subjective public policy concerns should be rendered of no consequence. By contrast, however, under the Full Faith and Credit Clause of the U.S. Constitution (Article IV, § 1), a domestic asset protection trust jurisdiction does not have the option of disregarding duly rendered judgments of its sister states. Such a domestic trust is inherently less protective because that trust remains subject to the vagaries of an often intemperate judiciary.

Additional myriad considerations of somewhat lesser significance, but by no means inconsequential, must be considered in choosing the law that will be designated as governing the trust. Those considerations include the following:

1. The effect of the local tax regime upon the trust

2. The availability of professional trust services, ideally through a trustee with which an effective working relationship has previously been established

3. The political and economic stability of the jurisdiction

4. The existence of language, cultural, or other barriers that make administration of the trust in that jurisdiction inconvenient

5. Other practical and psychological hurdles for a creditor attempting to enforce a claim against a trust sited in that jurisdiction

Drafting Considerations

Within the determination of a choice of law to govern the trust, a further universe of drafting considerations exists, with a potential for significantly impacting the protections afforded by the trust. For example, under Cook Islands law, "[a]n international trust..., shall not be declared invalid or a disposition declared void or be affected in any way by reason of the fact that the settlor, and if more than one, any of them, either — (d) is a beneficiary, trustee or protector of the trust or instrument, either solely or together with others" [Cook Islands International Trusts Act § 13C(g)].

Notwithstanding the foregoing, however, the very essence of being named as a trustee is direct control over the trust's assets. It would seem difficult if not outright impossible to reconcile a settlor's position as trustee with any reasonable level of asset protection for the trust fund.

In addition, the possibility of the settlor's acting as protector should be carefully considered in view of the result in *Federal Trade Commission v. Affordable Media, LLC, et al.*, 179 F.3d 1228 (9th Cir. 1999) [see also *In re Brooks* and *In re Portnoy*]. The settlors' position as the protectors of the trust gave them control over the trust at issue therein. That position vitiated their impossibility of performance defense when contempt proceedings were brought following their failure to repatriate the trust fund upon order of the District Court [179 F.3d 1228 at 1243]:

> The provisions of the trust also make clear that the Andersons' position as protectors gives them control over the trust [since] . . . whether or not an event of duress has occurred depends upon the opinion of the protector . . . It is clear that the Andersons could have ordered the trust assets repatriated simply by certifying to the foreign trustee that in their opinion, as protectors, no event of duress had occurred.

Tax Considerations

Finally, it is also extremely important to consider that the manner in which the trust is drafted for asset protection purposes can potentially implicate a host of U.S. tax issues. A foreign asset protection trust can, with careful forethought, be drafted so as to impart significant asset protection while at the same time being totally income and transfer tax neutral for U.S. tax purposes. The converse is that an inadvertent clause can prove disastrous from a U.S. tax standpoint.

From a transfer tax standpoint, a foreign asset protection trust will most often be crafted so that transfers to the trust are deemed "incomplete" for U.S. gift tax purposes. That practice allows the settlor to fund the trust without being constrained by the settlor's $1 million exemption from the gift tax and without incurring gift tax. The trust can be settled so that transfers to the trust are deemed "incomplete" for U.S. gift tax purposes by including a power of appointment [see Treas. Reg. § 25.2511-2(b)]. To the extent that the power is limited in its scope of potential appointees, the settlor's possession of such a power should not implicate any asset protection issues.

Under certain circumstances, of course, it may be desirable to structure the foreign asset protection trust so that transfers will be deemed to be completed gifts for gift tax purposes. In that manner, any appreciation to the value of the trust fund will be removed from the settlor's gross estate. In fact, by settling the trust in a jurisdiction that recognizes the validity of self-settled trusts against claims of the settlor's creditors, the settlor can remain a discretionary beneficiary of the trust while nevertheless excluding it from his or her estate [see, e.g., Rev. Rul. 76-103, 1976-1 CB 293].

From an income tax perspective, a "foreign trust" is generally required to file Form 3520-A, *Annual Information Return of a Foreign Trust with a U.S. Owner*, and the settlor of such foreign trust must file Form 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts.* In addition, the settlor of the foreign trust must report the existence of such trust by checking the appropriate box on Part III of Schedule B of Form 1040, *United States Individual Income Tax Return.*

It is often desirable to structure the foreign asset protection trust as a "United States person" under Internal Revenue Code § 7701(a)(30)(E). Structuring the foreign asset protection trust as a U.S. person will avoid the additional tax information reporting that is required for foreign trusts.

Such a foreign trust is sometimes called a "hybrid" trust, since it applies foreign law as the governing law but is

deemed a domestic trust for tax purposes. Such a hybrid trust is possible under Treas. Reg. § 301.7701-7, since the test for determining a domestic trust under that section merely requires that . . .

1. A court within the United States is able to exercise primary supervision over the administration of the trust, and

2. One or more U.S. persons have the authority to control all substantial decisions of the trust.

Therefore, the designation of foreign law as governing the trust does not violate the trust's domestic status. Similarly, the presence of a majority of domestic trustees, together with a foreign co-trustee, also does not violate the trust's domestic status. Of course, from an asset protection perspective, it is generally preferable that U.S. persons not act as either protector or trustee. A judgment must be made as to whether the desire for domestic trust status is outweighed by the compromise to asset protection under such a trust.

Conclusion

Self-settled spendthrift trusts, unlike spendthrift trusts created exclusively for the benefit of others, generally cannot be created under the laws of most of the United States. If the planner develops a practice with a global scope, however, the planner can achieve for his or her clients significant protections against the claims of potential future creditors through the use of self-settled spendthrift trusts.

At the same time, the complexity of that area of planning, situated as it is at a crossroads of legal and practical disciplines, requires at a minimum that the planner be well versed in both the law of the planner's own jurisdiction, as well as the law of a host of offshore jurisdictions [consider, for example, DR 6-101(A) of the Model Code of Professional Responsibility, as well as Rule 1.1 of the Model Rules of Professional Conduct]. The benefits, both to the planner and to his or her clients, however, will likely warrant a consideration of that very effective tool under the appropriate circumstances.

Editor's note: The authors will discuss the use of asset protection trusts for estate planning objectives in the next issue of Estate Tax Planning Advisor.

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Qualified Subpart E Trusts

Deemed Owner Trusts as S Corporation Shareholders

By Sydney S. Traum

Only certain types of trusts are permitted to be shareholders of S corporations without causing termination of the S corporation status. Among the permitted classes of trusts are Qualified Subpart E Trusts that are treated as entirely owned by one individual for income tax purposes under the rules of Internal Revenue Code (IRC) sections 671 through 679.

The deemed owner of such a trust must be a U.S. citizen or qualify for income tax purposes as a U.S. resident. Often the deemed owner is the grantor of the trust; such trusts are commonly called "grantor trusts." If the grantor is not deemed to be the owner of the trust, sometimes another individual holds the requisite powers and is treated as the deemed owner under Section 678. The following discussion examines some of the private letter rulings involving Qualified Subpart E Trusts.

When Grantor Is Deemed Owner

In the situations considered in letter rulings 9037011, 9048027, 9504021, and 9508007, the grantor of the trust was treated as the deemed owner of the trust.

Letter Ruling 9037011

The trust in Letter Ruling 9037011 gave the grantor the right to acquire any property then held in trust (or any succeeding trust) by substituting property of equivalent value exercisable in a nonfiduciary capacity. The grantor could acquire that property without approval or consent of any person acting in a fiduciary or nonfiduciary capacity.

IRC Section 675(4) treats the grantor as the owner of a portion of the trust over which he has a power of administration exercisable in a nonfiduciary capacity without the approval or consent of any person in a fiduciary capacity. The power to reacquire trust corpus by substituting other property of equivalent value is considered a power of administration under Section 675(4)(C). As a result, the grantor is treated as the deemed owner of the trust, which is treated as a grantor trust that qualifies as an S corporation shareholder.

Letter Ruling 9048027

Letter Ruling 9048027 examined a situation in which the grantor retained the right to income for 10 years and to