"IRREVOCABLE PURE GRANTOR TRUSTS": THE ESTATE PLANNING LANDSCAPE HAS CHANGED

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INTRODUCTION

Robert and Patricia Richards are seventy-five years old. They have three children. Their youngest, Philip, has Multiple Sclerosis, but is currently healthy and employed. He is married, has no children, and lives paycheck-to-paycheck. Robert and Patricia do not care for his wife (although they would never share that). The Richards' daughter Emily is married with three children. She is a teacher and her husband is a nice man, but is on his third business. The first two businesses were successful for a while, but eventually failed. Robert Jr., the oldest, is a

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doctor, married with five children and is financially well off. The Richards have a net worth of $577,000 consisting of $152,000 in bank accounts, $250,000 in brokerage accounts, a home (paid off) with a value of $150,000, and two cars and miscellaneous other assets valued at $25,000. Their pension and Social Security provide $3000 a month, which they live on comfortably and still are able to save. The Richards go on a cruise each January and September and like to visit their grandchildren several times a year. They have helped Phillip and Emily financially in the past. They are both healthy, but are concerned a lawsuit, stroke, or other catastrophe could wipe out their life savings and their current lifestyle. While they do not use their assets to live on, they want to make sure they are available in an emergency. They recently attended a seminar, and the lawyer giving it said it was important to avoid probate and that if they died with more than one million dollars in assets, the state would assess an estate tax. The lawyer also said the cost of a nursing home exceeded $6,000 per month, and they would have to give all their assets away if they wanted to qualify for Medicaid to pay for a nursing home. They decided it was time to do some planning to protect their lifestyle and the little bit they managed to save. They want to maintain control of their assets (the kids can have the assets when they are done with them), remain independent and keep their plan as simple as possible. They were thrilled to learn about the Irrevocable Pure Grantor Trust![1]

This article will describe how the Irrevocable Pure Grantor Trust can be used to help clients who are not subject to estate tax, but want to maintain control and protect what they have, for their needs and their family. It will provide an objective analysis of several areas of law and include statistics, legal citations and other scholarly writings that demonstrate how the legal strategies or features[2] used in the Irrevocable Pure Grantor Trust make it uniquely different from other irrevocable trusts. Experts have different opinions on the impact of these features when used in an irrevocable trust where the grantor retains a benefit ("self-settled trusts"), but the analysis will confirm universal agreement and well established law on the applicability of each legal feature and

1. "Irrevocable Pure Grantor Trust" is a term created by the author to identify the trust discussed in this Article. The term and its origin are discussed in Section I. This Article will examine the features of the Irrevocable Pure Grantor Trust and provide a legal analysis of the impact of its features. The author has used this trust for more than fifteen years for thousands of clients and holds a trademark for iPug™ trust to describe his application of the features in a software program that achieves specific client results. This Article will not discuss his methods or use of the features to create an iPug™ trust.

2. In this Article, I will use the term "feature" to illustrate different legal strategies commonly used in trust planning.

its result when used in the Irrevocable Pure Grantor Trust. It is easy for attorneys to become confused and disagree on the impact of a feature when a different outcome can occur when it is used in different legal contexts. For example, retaining a "power of appointment" to a grantor produces a different result when used in a trust intended for tax, asset protection, Medicaid, or general estate planning purposes.[3] In addition, variations of a feature, such as a "general," "non-general," or "limited" power of appointment, when used in each area of planning, can have a significantly different impact.[4] What makes it confusing is that a negative impact created by using a feature in one planning area, may cause a positive impact in another.

Section I will analyze the tax law treatment of trusts and identify commonly used terms to distinguish the tax treatment when different legal features are included in a trust. Section II will identify the features used in the Irrevocable Pure Grantor Trust and show how they are different from what has traditionally been used in irrevocable trusts, but utilize well settled principles of law to avoid being subject to the grantor's creditors. Section III will outline the primary uses of Irrevocable Pure Grantor Trusts to meet current client needs and distinguish the different types available to accomplish different client objectives. Finally, Section IV will differentiate the Domestic Asset Protection Trust (DAPT) from the Irrevocable Pure Grantor Trust and show why the Irrevocable Pure Grantor Trust is not subject to the legal scrutiny and controversy of the DAPT. This Article will demonstrate how the tax, asset protection, estate planning, and control features of the Irrevocable Pure Grantor Trust provide the answer to Mr. and Mrs. Richards' goals as well as the goals of business owners, professionals and other Americans not subject to estate tax, but desirous to maintain control, protect their assets, and ensure their assets get to their loved ones with as much flexibility and protection as possible, but minimizing complexity.

I. TAX TREATMENT OF THE IRREVOCABLE PURE GRANTOR TRUST

A primary concern when drafting trusts is a determination of how it will be taxed. The tax treatment by the Internal Revenue Service (IRS) and state taxing authorities impacts heavily on an attorney's choice of trust and the features utilized to accomplish the individual goals of clients. The IRS imposes different types of taxes and rates depending on whether a taxpayer is an individual or other entity such as

3. *See infra* text accompanying notes 62-72.
4. *See infra* text accompanying notes 62-66.

a corporation, limited liability company, estate, or trust.[5] The most common taxes are income (ordinary and capital gain), gift, estate, generation-skipping, and excise taxes.[6] The government imposes higher tax rates and/or additional taxes to discourage planning strategies that postpone the receipt of taxable income, that shift income to a taxpayer in a lower tax bracket or attempt to reduce, or avoid the application of a particular tax to the entity created.[7]

When a trust is created by an individual, the IRS will tax the trust as: (1) a non-taxed entity, commonly known and referred to herein as a "grantor trust," wherein the grantor of the trust is deemed to be the owner of the trust corpus and all taxes are passed through to the grantor as if the trust did not exist; (2) a separate taxpaying entity, commonly known and referred to herein as a "non-grantor trust," since the grantor of the trust is not deemed to be the owner of the trust corpus for tax purposes; or (3) as a grantor trust for income taxes, and a non-grantor trust for estate taxes, commonly known as and referred to herein as a "defective grantor trust."[8] To determine the tax treatment of a trust, the IRS will look at the trust terms. If one of the conditions set forth in the Internal Revenue Code (IRC) sections 671-679 is triggered, the trust income is taxed to the grantor.[9] If the trust contains terms that trigger a condition in IRC sections 2035-2042, the trust assets will be included in the estate of the grantor and subject to estate tax at death.[10] If the trust terms trigger both a grantor trust and estate tax condition, it is taxed as a grantor trust.[11] Conversely, if the trust terms do not trigger conditions cited in either the grantor trust or estate tax sections of the IRC, the trust

5. *See, e.g.*, I.R.C. §§ 1, 2001, 3101, 4001 (2006) (Income, Estate and Gift, Employment, and Excise Taxes respectively).

6. *Id.*; *see also id.* § 2601 (Generation Skipping Taxes).

7. *See, e.g.*, *id.* § 2001 (providing for estate tax rates as high as 55% starting in 2011). *But see* I.R.C. § 1 (Supp. 2010) (imposing a maximum income tax effective rate of 35%). Further, the highest rate of income taxes on individuals is effective at $373,650, whereas the highest rate of income tax on trusts occurs at only $11,200. I.R.C. § 1 (2006); *see infra* note 40.

8. *See* 3 J. STODDARD HAYES, JR., ESTATE TAX & PERSONAL FINANCIAL PLANNING § 30:24 (2010). *See also generally* Steve R. Akers, *Planning with Grantor Trusts – Structuring a Grantor Trust to Maximize the Benefits and Minimize the Risks*, American Law Institute, SP053 ALI-ABA 687 (2009); Jay A. Soledal, *Reforming the Grantor Trust Rules*, 76 NOTRE DAME L. REV. 375, 377 (2001); Richard A. Courtney, *How to Protect Elderly Clients Assets*, National Business Institute, 37343 NBI-CLE 57 (2007); Lawrence Brody, *Uses of Insurance in Estate & Tax Planning*, American Law Institute, SM087 ALI-ABA 309 (2007).

9. *See* I.R.C. §§ 671-79.

10. *See id.* §§ 2035-42.

11. *See supra* note 8.

is taxed as a non grantor trust.[12] Defective grantor trust tax treatment occurs if a grantor trust condition is triggered, but an estate tax condition is not.[13]

Grantor trusts are traditionally used when a grantor wishes to benefit from the trust or maintain some control. When grantor trusts are used, the grantor is generally not concerned with being treated as the owner for income or estate tax purposes as he or she may need the income and not have enough assets to be subject to the estate tax. The converse of a grantor trust is a non-grantor trust, which permits a grantor to avoid being taxed on the income or having the trust corpus subject to estate tax at death.[14] In my experience, non-grantor treatment is especially beneficial to grantors who are subject to estate tax and whose income tax rate is higher than the trust income beneficiaries. In contrast, I find, defective grantor trusts are generally used by individuals who want to avoid the estate tax at death, but who wish to be taxed on the trust income during their life in order to provide additional untaxed benefit to trust beneficiaries and reduce estate tax. A grantor is limited to a $13,000 gift tax exemption per beneficiary, per year.[15] If the grantor pays the income tax on the trust income, the gross trust income, rather than the after tax trust income is distributed to the trust beneficiaries, thus increasing the benefit to them without creating an additional gift by the grantor, subject to the annual gift tax exemption limit.[16] In addition, the income tax paid by the grantor reduces the size of his estate subject to estate tax, thereby avoiding the estate tax on the amount of income tax paid.[17]

The grantor will be treated as the owner of the trust for *income tax purpose* on all or that portion of a trust in which the grantor retains any of the following: a reversionary interest in the income or principal of the trust that exceeds five percent of its value;[18] the power to control the

12. *See supra* note 8.

13. *See supra* note 8.

14. *See supra* note 8.; *see also* I.R.C. § 641.

15. I.R.C. § 2503(b); *see also* 34B AM. JUR. 2D *Federal Taxation* ¶ 148,203 (2009). This Article will not discuss the gift tax rules or rates.

16. Applying the foregoing laws, when grantor trust status is applicable, the income tax on the trust income is paid by the grantor individually out of his assets, not the trustee out of trust assets. As a result the trust beneficiaries are able to receive the gross trust income. The payment of income taxes by grantor is proper since the grantor trust provisions require it and as a result, no gift has occurred by the payment of the income tax.

17. Further, since the grantor paid the income tax with his assets, the income tax paid reduces the assets subject to the grantor's estate tax, thus reducing his estate tax liability.

18. *See* I.R.C. § 673(a).

beneficial enjoyment of the income or principal of the trust;[19] the power to purchase, exchange, or dispose of trust principal for less than adequate consideration, borrow money from the trust without adequate interest or security on the loan, or retain general administrative powers over trust assets such as the power to reacquire trust assets by substituting other property of an equivalent value;[20] the power to revoke the trust and reclaim the assets;[21] a right to income for himself or herself or for a spouse without the consent of an adverse party or the right to the trustee to pay premiums on life insurance on the grantor or his or her spouse.[22] In addition, individuals other than the grantor can be treated as the owner of a trust for income tax purposes, if the individual has the sole right to vest the principal of the trust in himself,[23] or if he/she transfers assets to a foreign trust with a United States beneficiary.[24]

While the foregoing provisions cause the grantor to be treated as the owner for income tax purposes, the assets in a trust will be included in calculating the estate tax of a deceased grantor if the grantor does any of the following: retains, for his or her life, the right to possess or enjoy the property transferred to the trust;[25] retains, for his or her life, the right to the income from the property transferred to the trust;[26] retains the right to designate who will possess or enjoy the trust property;[27] retains a reversionary interest in excess of 5% of the transferred property;[28] retains the right to alter or amend or revoke the trust;[29] is deemed to have retained a general power of appointment over the trust assets;[30] is deemed to have retained an incident of ownership over a life insurance policy or transferred to trust;[31] or made a transfer of, or relinquished any of the foregoing rights within three years of death.[32]

19. *Id.* § 674(a).
20. *Id.* § 675(1)-(2), (4).
21. *Id.* § 676(a).
22. *Id.* § 677(a)(3).
23. *See* I.R.C. § 678(a)(1). Note that a power to vest the principal in oneself is commonly referred to as a "general power of appointment." *See infra* text accompanying note 63.
24. I.R.C. § 679(a)(1).
25. *Id.* § 2036(a)(1).
26. *Id.*
27. *Id.* § 2036(a)(2). This is commonly referred to as a power of appointment. *See infra* text accompanying notes 62-72.
28. I.R.C. § 2037(a)(2).
29. *Id.* § 2038(a)(1).
30. *Id.* § 2041(a)(2).
31. *Id.* § 2042.
32. *Id.* § 2035(a)(1).

So what is an Irrevocable Pure Grantor Trust and how is it taxed? A "pure grantor trust" is a term I have used in speaking, educating, and training thousands of attorneys and other professionals over the past ten years. It is meant to distinguish a grantor trust from a non-grantor or defective grantor trust. Adding "pure" to "grantor trust" clarifies the trust is a grantor trust for both income and estate tax purposes. The distinction helps avoids confusion with the defective grantor trust, which is also classified as a "grantor trust," but only for income tax purposes. Revocable trusts are taxed as a pure grantor trust, while most irrevocable trusts are taxed as non-grantor trusts or defective grantor trusts. Some trusts are taxed as a grantor trust or non-grantor trust, depending on if the grantor dies while still benefitting from the trust. A "split interest trust" is created when there is a split between the grantor's current interest and future interest. Split interest trusts are taxed as pure grantor trusts when created but, by the terms of the trust, can change to a non-grantor trust. For example, a grantor-retained annuity or unit trust (GRAT/GRUT), a qualified personal residence trust (QPRT), and a charitable lead trust (CLT) are all trusts that provide the grantor the income, or the right to benefit, for a period of time during the grantor's life, which qualifies it for pure grantor trust treatment; however, by the trust terms, the grantor's right to income or benefits terminates during the grantor's life, converting it to a non-grantor trust. The risk to creating a split interest trust, however, is if the grantor's rights in the trust do not terminate prior to the grantor's death, pure grantor status will be retained and the assets of the trust will unintentionally be included in the grantor's estate and taxed accordingly.[33] The ability to delineate pure grantor trusts as either revocable or irrevocable creates a whole new genre of irrevocable trusts not previously identified. To illustrate the appeal of this new genre of trust, we must first understand how the Irrevocable Pure Grantor Trust is taxed.

The income and estate tax treatment of a pure grantor trust is a blessing or a curse, depending on the goals of the client. Since pure grantor trusts are taxed to the owner, they are tax neutral and have the same tax treatment as if the grantor did not create the trust. As such, pure grantor trusts are not likely to be the trust of choice for individuals who wish to minimize their income or estate tax. Estate tax planning for individuals with estates of $3.5 million or more, accounts for only three in one thousand American taxpayers, less than one third of one

33. I.R.C. § 2036; Treas. Reg. §§ 20.2031-7, 20.2036-1(c) (2009) (determining the proper amount of the trust included in the grantor's estate).

percent.[34] The number of individuals subject to estate tax only creeps up slightly less than eighteen in one thousand or 1.76% of American taxpayers if the estate tax exemption is reduced to a $1 million dollars.[35] Even with the current estate tax laws in transition, the number of Americans needing estate tax planning is insignificant, thus making pure grantor tax status the tax treatment of choice for virtually all Americans. In fact, inclusion of trust assets in the grantor's estate has significant benefits over giving the assets to beneficiaries or a non-grantor trust during the grantor's life. A grantor's lifetime gift is not only subject to gift tax rules, but it also creates a "carry over" tax basis to the transferee, as compared to a distribution to a beneficiary or non-grantor trust after the grantor's death, which creates a "step up" in tax basis to the trust beneficiaries.[36] Additionally, since most Americans are not independently wealthy, they must rely on the income from their assets to support their lifestyle during retirement and do not object to the inclusion of trust income on their personal income tax return. Another appealing feature of pure grantor trusts is that no special or separate tax filings are required, even if it is an Irrevocable Pure Grantor Trust.[37] Transfers to the trust by the grantor have no income or gift tax consequence, and its inclusion in the estate of the grantor provides the beneficiaries a step-up in basis.[38] Non-grantor trusts on the other hand, subject the grantor to the gift tax rules and require the filing of a gift tax

34. NONNA A. NOTO, CONG. RESEARCH SERVICE, R40964, ESTATE TAX LEGISLATION IN THE 111TH CONGRESS, at 3 (2010).

35. *Id*. at 36-37.

36. I.R.C. §§ 1014(a)(4), 1015(a)-(b) (explaining that a carry-over tax basis means the recipient of the asset receives it at the tax basis of the donor or grantor so if sold by the recipient, he or she pays income tax on the difference between what the donor paid and what the recipient sold it for). Conversely, a stepped-up basis means the recipient receives the asset at its fair market value at time of receipt and only pays income tax on the increase in value from the date received. *Id*. The stepped-up basis rules under section 1014 applied differently in 2010 when the estate tax has been eliminated. I.R.C. section 1022 provided for a modified carry-over basis on assets of decedents who die in 2010 to allow a step-up in the basis of the decedent's assets of up to $1.3 million and an additional $3 million of step up in basis of a decedent's assets that pass to a surviving spouse. *See id.* § 1022(d)(4)(A).

37. Trustees of pure grantor trusts are not required to obtain a separate tax identification number (known as an employer identification number or EIN) for the trust since the grantor is deemed to be the owner. *See Employer ID Numbers (EINs)*, INTERNAL REVENUE SERVICE, http://www.irs.gov/businesses/small/article/0,,id=98350,00.html (last visited Nov. 24, 2010). The grantor's Social Security number is used as the identification number for the trust. The trustee may opt to apply for a separate EIN for a pure grantor trust, but all tax is to be reported on the tax return of the grantor. *See* Treas. Reg. § 1.671-4(b) (2010); *Instructions for Form 1041 and Schedules A, B, G, J, K-1*, INTERNAL REVENUE SERVICE, *available at* http://www.irs.gov/instructions/i1041/ch02.html (for information on optional reporting methods).

38. *See supra* note 36.

return, as well as a separate trust tax identification number for the filing of annual income tax returns.[39] In addition, the income tax rates for non-grantor trusts are not favorable. The top income tax rate is assessed on non-grantor trusts with incomes of only $11,200, as compared to individuals (grantors) who pay the top tax rate when incomes exceed $373,650.[40]

While a revocable trust provides the simplicity of pure grantor tax status, it may no longer be enough to meet an individual's planning needs. Many events over the last ten years have impacted how individuals perceive their personal and financial security. When the stock market grew at record rates during the 1990s, Americans got very comfortable. The new millennium, however, brought a major stock market decline in 2001, when the technology bubble burst, and the World Trade Center bombings rocked Americans' confidence in their safety. Enron and other corporate scandals, combined with major bank, insurance, and auto industry failures, the collapse of the housing market in 2008, and the worst recession since the Great Depression, has also changed how individuals view their personal and financial safety. The number of lawsuits and the increased costs of nursing home care also increase individuals' desire for protection; more than 103 million lawsuits were filed in all US courts in 2007 alone,[41] and the national average cost of a nursing home has reached approximately $6,000.00 per month, and more than $12,000.00 per month in one state.[42] These costs threaten individuals with losing assets that took them a lifetime to accumulate. Revocable trusts do not provide the asset protection clients seek, and the complexities of non-grantor or defective grantor trusts, in the absence of any estate tax concerns, makes them undesirable. Irrevocable Pure Grantor Trusts have become the trust of choice for individuals who want to protect their assets and have the simplicity of pure grantor tax treatment.

39. Treas. Reg. § 1.671-4(b) (2009).

40. I.R.C. § 1(a)-(e).

41. John E. Sullivan III, Address at the Ohio State Bar Association 2010 Annual Convention, Asset Protection Planning: A Brief Overview (2010 Version): LLCs and LPs-Charging Orders, Creditors' Rights, and Other Issues: The Basics of Asset Protection Trusts (May 5-7, 2010).

42. *Costs of Care?*, U.S DEP'T OF HEALTH & HUM. SERVICES, http://www.longtermcare.gov/LTC/Main_Site/Paying_LTC/Costs_Of_Care/Costs_Of_Care.aspx (last visited Nov. 24, 2010) (costs of $198 or $219 per day for a semi-private or private room in a nursing home respectively).

II. FEATURES OF IRREVOCABLE PURE GRANTOR TRUSTS

The features of Irrevocable Pure Grantor Trusts are extensive. In its true form, similar to a revocable trust, an Irrevocable Pure Grantor Trust can permit a grantor the power to: (1) be the sole or co-trustee; (2) retain the right to change the current and remainder beneficiaries and the timing, manner, and method of distribution, ("power of appointment"); and (3) modify and amend the powers of the trustee, appointment of trustee or trust protector, and the trust's administrative provisions. To achieve asset protection, the grantor must irrevocably give up all rights or power to himself, a trustee, or any third party, to grant access to that which he or she chooses to protect.[43] The irrevocable restrictions opted for are outside the reach of the grantor by well established contract and common law principles, many of which have become codified in the Uniform Trust Code[44] and the Restatements, Second and Third, of Trusts.[45] For example, grantors traditionally did not act as trustees in an irrevocable trust because estate tax avoidance was a primary goal and a grantor acting as trustee defeats estate tax avoidance.[46] Since less than one percent of Americans are subject to estate taxes, retaining the powers will not have any adverse impact on most, so the restrictions imposed by the IRC to achieve non-grantor or defective grantor status may be an unnecessary burden on them.[47] Practitioners must now look to the common law to determine how trusts will be treated for protection purposes rather than the tax law with concern for how it is treated for tax purposes. Attorneys can add or omit any feature or implement all or part of each feature, depending on their individual comfort level. The unique features of an Irrevocable Pure Grantor Trust permit clients the flexibility of pure grantor trust tax treatment afforded revocable trusts while providing the protection of irrevocable trusts.

An examination of each feature and the need to distinguish it from its traditional use in trust planning is critical to identifying the benefit of Irrevocable Pure Grantor Trusts. The grantor has the right to be trustee

43. For example, if the grantor wishes to obtain asset protection of the trust principal, the grantor must irrevocably give up all right and access to trust principal and prohibit the trustee or any third party any right to distribute it to the grantor. An analysis of asset protection will be discussed extensively later. *See infra* discussion Parts II, IV.

44. *See generally* UNIF. TRUST CODE § 411 (2000), 7C U.L.A. 497-98 (2006). For a list of states that have adopted the Uniform Trust Code, see 7C U.L.A. 362 (2006).

45. *See generally* RESTATEMENT (THIRD) OF TRUSTS §§ 61-65 (2003); RESTATEMENT (SECOND) OF TRUSTS §§ 331-347 (1959).

46. *See* I.R.C. § 2036 (2006).

47. *See generally id.* §§ 671-79, 2035-42.

of a trust he or she creates.[48] The grantor as trustee has been universally used in revocable trusts but not in irrevocable trust planning since retaining the right makes it a pure grantor trust.[49] The grantor as trustee in an irrevocable Charitable Remainder Trust is acceptable since it is a grantor trust.[50] The grantor serving as trustee does not expose the trust assets to personal claims against the grantor,[51] even if the grantor retains a right to its income.[52] The grantor, as trustee, has the same fiduciary duties to the beneficiaries as any other trustee.[53] It is also well settled law that the assets of a trust are not subject to the personal claims against the trustee, even if the liability arises out of his trustee capacity.[54] Further, it is well settled a trustee is prohibited from self-dealing or acting in his or her own best interest.[55] "Nothing in the law is better settled than that a trustee may not advantage himself or herself

48. *See* RESTATEMENT (THIRD) OF TRUSTS § 32; RESTATEMENT (SECOND) OF TRUSTS § 100; *see also In re* Prudence Co., Inc., 24 F. Supp. 666, 668 (E.D.N.Y. 1938).

49. *See* I.R.C. § 674 (regarding the power to control beneficial enjoyment); *id.* § 2042 (regarding incidents of ownership).

50. *See* GEORGE M. TURNER, IRREVOCABLE TRUSTS § 30:8 (3d ed. 2009).

51. *See* RESTATEMENT (SECOND) OF TRUSTS § 99(2) cmt. b. *See also* Markham v. Fay, 74 F.3d 1347, 1355-56 (1st Cir. 1996) (providing a thorough analysis of the availability of assets in a trust where the grantor is the trustee. Citing U.S. Supreme Court cases, the ruling is consistent with the Restatement Second of Trusts section 156 in illustrating the government could only access what the grantor retained a right to); 1 AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, THE LAW OF TRUSTS § 99.3 (4th ed. 1987); RESTATEMENT (SECOND) OF TRUSTS §§ 100, 156(2).

52. *See* United States v. Baldwin, 391 A.2d 844, 848 (Md. 1978) (cited extensively regarding the well established principle that creditors can only get what the grantor retains a right to. In *Baldwin*, the right to income did not expose the trust assets to the claims of the Grantor). *See also* Domo v. McCarthy, 612 N.E.2d 706, 709 (Ohio 1993); *In re* Hotel St. George Corp., 213 N.Y.S.2d 163, 164-65 (Sup. Ct. 1961) (citing 1 AUSTIN WAKEMAN SCOTT, SCOTT ON TRUSTS § 17.1 (2d ed. 1956)); GEORGE GLEASON BOGERT & GEORGE TAYLOR BOGERT, THE LAW OF TRUSTS & TRUSTEES §19 (1951)); RESTATEMENT (SECOND) OF TRUSTS § 156.

53. *Baldwin*, 391 A.2d at 849. *See also* 34A AM. JUR. 2D *Federal Taxation* ¶ 143,415 (2009) (citing Treas. Reg. § 20-2038-1(a) (2009)); Estate of Loughridge v. Comm'r, 11 T.C. 968, 976 (1948), *nonacq.* 1949-2 CB 4, *aff'd* 183 F.2d 294 (10th Cir. 1950); Estate of Klauber v. Comm'r, 34 T.C. 968, 976 (1960), *nonacq.* 1964-2 C.B. 8, *nonacq.* 1964-2 C.B. 9.

54. *See* RESTATEMENT (SECOND) OF TRUSTS § 266. *See also* Lagae v. Lackner, 996 P.2d 1281, 1284 (Colo. 2000); Richion v. Mahoney, 133 Cal. Rptr. 262, 264-65 (Cal. Ct. App. 1976); GEORGE GLEASON BOGERT & GEORGE TAYLOR BOGERT, THE LAW OF TRUSTS & TRUSTEES § 146 (2d rev. ed. 1979); SCOTT & FRATCHER, *supra* note 51, § 266. *But see* RESTATEMENT (SECOND) OF TRUSTS § 271A; SCOTT & FRATCHER, *supra* note 51, § 271A (identifying a recent trend to permit creditors of the trustee access to trust assets if the liability arises out of the trustee's administration of the trust).

55. *See* RESTATEMENT (THIRD) OF TRUSTS § 78 (2003); RESTATEMENT (SECOND) OF TRUSTS § 170.

in dealings with the trust estate."[56] The grantor's creditors are only entitled to income or assets available to the grantor in a self-settled trust.[57] Accordingly, since the trust, by its terms, prohibits distribution of the principal and/or income to the grantor and no discretion is permitted to the trustee or anyone else to distribute to the grantor, it cannot be reached by the grantor's creditors.[58] It is easy to combine concepts associated with self-settled trusts with asset protection rules, but a thorough review of the law reveals such assumptions are unfounded.[59] No authority in statute, common law, Uniform Trust Code or the Restatement Second or Third of Trusts permits access to the income and/or principal of a trust to the grantor's creditors, absent the grantor's retained right to the trust assets or fraud.[60] Any concern that the grantor serving as trustee of an Irrevocable Pure Grantor Trust exposes the assets or income to creditors of the grantor, when no rights to the assets were retained by the grantor, begs the question of what law or precedent will be utilized to support such a position?[61]

The grantor in an Irrevocable Pure Grantor Trust can also retain the power to change the current and remainder beneficiaries and the timing, manner, and method of distributions to the beneficiaries, by using a power of appointment.[62] The most powerful is a general power of appointment, which permits an individual to change the trust beneficiaries to anyone, including the individual holding the power.[63] A non-general power of appointment is almost as powerful, but prohibits the power holder from exercising the power in favor of himself, his

56. *See* 76 AM. JUR. 2D *Trusts* § 351, n.9 (2005) (citing Gibson v. Sec. Trust Co., 107 F. Supp. 766 (N.D.W.V. 1952), *aff'd*, 201 F.2d 573 (4th Cir. 1953); Morrison v. Asher, 361 S.W.2d 844 (Mo. Ct. App. 1962)).

57. *See* UNIF. TRUST CODE § 505, 7C U.L.A. 534-35 (2006). RESTATEMENT (THIRD) OF TRUSTS § 58(2); RESTATEMENT (SECOND) OF TRUSTS § 156(2); 3 AUSTIN WAKEMAN SCOTT ET AL., SCOTT & ASCHER ON TRUSTS § 15.4.3 (5th ed. 2007); BOGERT & BOGERT, *supra* note 54, § 223.

58. *See* RESTATEMENT (THIRD) OF TRUSTS §§ 58, 60; RESTATEMENT (SECOND) OF TRUSTS §156.

59. *See infra* Section IV.

60. *See generally* UNIF. TRUST CODE §§ 501-03, 7C U.L.A. 523-25 (2006); RESTATEMENT (THIRD) OF TRUSTS §§ 58, 59; RESTATEMENT (SECOND) OF TRUSTS §§ 266-73. *See also infra* Section IV.

61. It is presumed the grantor will not retain any right to the principal of the trust. The grantor may also choose to give up any right to income from the trust. The uses and types of Irrevocable Pure Grantor Trusts are outlined further *infra*, Section III.

62. *See* 26 C.F.R. § 20.2041-1(b) (2010).

63. *See id*. § 20.2041-1(c) (2010). *See also* RESTATEMENT (THIRD) OF PROPERTY: WILLS & OTHER DONATIVE TRANSFERS § 17.3(A) (2006); RESTATEMENT (SECOND) OF PROPERTY: DONATIVE TRANSFERS § 11.4(1) (1986); 62 AM. JUR. 2D *Powers of Appointment, Etc.* § 13 (2005).

creditors, his estate or the creditors of the power holder's estate.[64] The most restricted power of appointment limits the power holder to exercise the power only to the limited class of beneficiaries identified by the grantor, thus referred to as a limited power of appointment.[65] While a general power of appointment will cause the assets of a trust to be included in the taxable estate of the individual holding the power, a limited or non-general power of appointment will not.[66] Similarly, a general power of appointment retained by the grantor will subject the assets over which the power is retained to the claims of the grantor's creditors.[67] Creditors cannot, however, attach the interest of a beneficiary or third party who holds a power of appointment unless it is a general power of appointment[68] or the property transferred to the trust was a fraudulent conveyance.[69] Some authors have asserted that the grantor's retention of a power of appointment will subject the assets of the trust to the grantor's creditors.[70] It is without dispute, that in a self-settled trust, the grantor's creditors can gain access to that which the grantor retains a right, including the income from an income only

64. *See* 26 C.F.R. § 20.2041-1(c)(1)(a)-(b) (2010). *See also* RESTATEMENT (THIRD) OF PROPERTY: WILLS & OTHER DONATIVE TRANSFERS § 17.3(b) (Tentative Draft 2006); RESTATEMENT (SECOND) OF PROPERTY: DONATIVE TRANSFERS § 11.4(2) (1986).

65. *See* 62 AM. JUR. 2D *Powers of Appointment, Etc.* §14 (2005). *See also* SCOTT & FRATCHER, *supra* note 51, § 17.2.

66. *See* I.R.C. § 2036(a)(2) (2006).

67. *See* SCOTT ET AL., *supra* note 57, at § 15.4.1.

68. *See* Bynum v. Campbell, 419 So. 2d 1370, 1375-76 (Ala. 1982).

69. *See* 2 JOHN A. BORRON, JR., THE LAW OF FUTURE INTERESTS § 944 (3d ed. 2003) (stating "[i]n the absence of statute, the creditors of a donee cannot reach an unexercised power of appointment. The law recognizes no exception to this proposition. It is a rigid and inexorable as the multiplication table or a theorem in geometry"). *See also* RESTATEMENT (SECOND) OF PROPERTY: DONATIVE TRANSFERS §13.1. The only noted exception being Wisconsin Statute 702.17 providing that a non-general power of appointment can be subject to the claims of the power holder's creditors. Wis. Stat. Ann. § 702.17 (West 2001). Note the distinction in *Clapp v. Ingraham*, 126 Mass. 200, 203-04 (Mass. 1879), as settled law that when an individual *exercises* his or her general power of appointment, the property becomes part of their estate and subject to the claims of their creditors. *See also* Jordan v. Caswell, 450 S.E.2d 818, 819 (Ga. 1994). *But see* Henderson v. Collins, 267 S.E.2d 202, 206 (Ga. 1980) (where the court permitted the creditors access to a trust, but distinguished that it did not qualify as a discretionary trust and that the trust terms required it to terminate and distribute to the beneficiary).

70. *See* Mark Merric & Robert D. Gillen, *Asset Protection for the Middle Class*, TRUSTS & ESTATES, May 2010, at 24. While the authors distinguish Irrevocable Income only Trusts as being used for Medicaid qualifying purposes, it appears the logic and analysis used could also apply to Irrevocable Pure Grantor Trusts. *See id.* The authors suggest the use of a state specific statutory Domestic Asset Protection Trust (DAPT) is a preferred method for asset protection. *See id.* *See also infra* Section IV, which will distinguish the difference between DAPT's and Irrevocable Pure Grantor Trusts.

trust.[71] No legal precedent exists to permit a creditor to make a claim against an interest in a self-settled irrevocable trust that the grantor has not retained.[72] It has also been suggested that Irrevocable Income Only Medicaid Trusts (IIOMT) protect assets from the claims made by the government, but not other creditors.[73] Federal Medicaid law limits the applicant to specified levels of income or resources to qualify for benefits.[74] The Medicaid rules for individuals who transfer assets to irrevocable income-only trusts to ensure the assets are not considered as an available resource when determining their eligibility have been restricted significantly.[75] Transfers to trusts under the federal Medicaid laws have the same limitations as well established asset protection laws.[76] In fact, using trusts to protect assets under Medicaid law is

71. *See* UNIF. TRUST CODE § 505 7C U.L.A. 534-35 (2006); RESTATEMENT (THIRD) TRUSTS § 58(2) (2003); RESTATEMENT (SECOND) TRUSTS §156(2) (1959). *See also supra* note 57.

72**.** *See* Merric & Gillen, *supra* note 70, at 25. Merric and Gillen cite Racketeer Influenced and Corrupt Organizations (RICO) Act, fraud, and many disciplinary actions against attorneys whom participated in planning strategies to defraud creditors. *Id.* at 26. I agree wholeheartedly with their analysis and note the issues cited apply to all attorneys practicing estate planning whether using non-grantor trust, pure grantor trusts, defective grantor trusts or DAPT's. Any assertion, however, that retention of a power of appointment amounts to a RICO violation or fraud, absent gross abuse circumstances similar to those cited, is unfounded.

73. *Id*. at 24. It is presumed the authors referring to an IIOMT for Medicaid eligibility is simply an irrevocable trust wherein the grantor retains a right to income. *Id.* Income only trusts have been used for many years and their application goes far beyond qualification for Medicaid benefits. I agree an income only trust may comply with federal Medicaid law in deeming the assets in the trust unavailable to the grantor in determining their Medicaid eligibility, but I cannot distinguish features between an IIOMT cited by the authors and an Irrevocable Income Only Trust. The authors also distinguish *Spetz v. New York Dept. of Health*, 737 N.Y.S.2d 524 (Sup. Ct. 2002), and *Verdow v. Sutkowy*, 209 F.R.D. 309 (N.D.N.Y. 2002), which held the assets of an irrevocable income only trust where the grantor retained a limited power of appointment were not an available asset in determining the grantor's Medicaid eligibility. *Id.* at 29. The authors assert these rulings are only applicable to Medicaid eligibility and not to asset protection. Merric & Gillen, *supra* note 70, at 29.

74**.** *See* 42 U.S.C. § 1396p(f)(1)(A).

75. *See id.* § 1396p(d)(3)(B)(i) (noting specifically that transfers to irrevocable trusts are considered transfers to which an ineligibility period results under 42 U.S.C § 1396p(c), since the assets are no longer considered available to the applicant). Note the changes made to these sections by the Omnibus Budget Reconciliation Act of 1993 and the Deficit Reduction Act of 2005, both which made transfers to trust more restrictive by creating longer periods of ineligibility.

76. *See* 42 U.S.C. § 1396p(d)(3)(B)(i) (2006) (stating the transfer to an irrevocable trust is deemed available to an applicant in determining eligibility "if there are any circumstances under which payment from the trust could be made to or for the benefit of the individual, the portion of the corpus from which, or the income on the corpus from which, payment to the individual could be made shall be considered resources available to the

subject to a more restrictive standard than for asset protection laws. While the transfer of assets to a properly drafted irrevocable trust, absent fraud or insolvency, can protect the assets from the grantor's creditors upon transfer, Medicaid law requires the transfer to be done more than five years prior to the grantor's application to avoid ineligibility for Medicaid benefits.[77] The court held in *Spetz v. New York State Department of Health*, that in the absence of evidence of a beneficiary's consent to terminate a trust, even when the grantor retained a power of appointment to remove a beneficiary who failed to consent to the grantor's request to terminate the trust, the assets of the trust were not available to the grantor.[78] The court further stated that to hold otherwise would be directly contrary to settled federal and state law providing for the protection of assets with the use of irrevocable trusts, since every trust would be presumed to be revocable under the state statute permitting an irrevocable trust to be revoked by consent of the parties.[79] The *Spetz* court further distinguished the dicta in *Case v. Fargnoli* citing *In re Reynolds*—"[a]s a practical matter, a power to change the remainder interests in a self-settled trust is very nearly a power to dispose of the principal,"[80]—which related specifically to an entirely different statute.[81] The court in *Case* ultimately ruled the assets were available because *under the terms of the trust, the trustees were authorized to distribute income and principal to him*.[82] While the court noted it was conceivable a grantor could pressure beneficiaries to make payments for the grantor's benefit, especially since the trustees were the

individual . . . ."). This language is virtually identical to the well established asset protection law cited in the Restatement of Trusts, which states "where a person creates for his own benefit a trust . . . , his transferee or creditors can reach the maximum amount which the trustee . . . could pay to him or apply for his benefit." RESTATEMENT (SECOND) OF TRUSTS § 156(2) (1959).

77. *See generally* 42 U.S.C. § 1396p(c). *See also* discussion of fraud and insolvency, *infra* Section III.

78. 737 N.Y.S.2d 524, 526 (Sup. Ct. 2002). In *Spetz*, the New York Department of Health argued the grantor's retention of a limited power of appointment made the assets of the trust available since the grantor held the persuasive power to remove any beneficiary who did not cooperate with a grantor, and to appoint someone willing to assist him in revoking the trust pursuant to state statute authorizing the termination of an irrevocable trust. *Id.*

79. *See id.* (citing *In re* Hoelzer v. Blum, 462 N.Y.S.2d 684 (App. Div. 1983) (wherein the court refused to permit access to the trust principal of the grantor who retained a right to income, pursuant to a state statute that permitted a court to allow access to principal of a trust for an income beneficiary)).

80. Case v. Fargnoli, 702 N.Y.S.2d 764, 766 (Sup. Ct. 1999) (citing *In re* Reynolds, 664 N.E.2d 1209, 1209 (N.Y. 1996)).

81. *See Spetz*, 737 N.Y.S.2d at 527.

82. *Id.* (citing *Case*, 702 N.Y.S.2d at 767).

beneficiaries, the trust did not provide for it and, notwithstanding, "their roles as trustees and beneficiaries must be considered as legally separate."[83] Even the court in *Case* acknowledged well-established law that creditors can only reach what the trustees are empowered to give the grantor.[84] Further, in *Verdow v. Sutkowy*, a federal district court held that although the grantor retained a limited power of appointment, in the absence of bad faith or fraud, the remote possibility of collusion between the grantor and beneficiaries should not be considered in determining whether the assets of the trust are available.[85] The decisions in *Spetz* and *Verdow* specifically cite the federal and state Medicaid law which states, "if there are any circumstances under which payment from the trust could be made to or for the benefit of the individual, the portion of the corpus from which, or the income on the corpus from which, payment to the individual could be made shall be considered resources available to the individual,"[86] the same language as used in well-established asset protection law.[87]

Consistent with the foregoing cases, the United States Court of Claims held that the assets of a trust were not available to the grantor's creditors when the trust permitted the trustee to distribute income and principal to the grantor with the consent of the remainder beneficiaries, who were the grantor's children.[88] While the grantor did not retain any power of appointment, the inverse was permitted by granting distributions to the grantor with the consent of her children, the remainder beneficiaries.[89] The power to permit the distribution to the grantor was the beneficiaries' power, not the grantor's power, which is the same restriction as if the grantor retained a limited power of appointment.[90] Even with the grantor's power to remove the remainder beneficiaries if they did not consent, the grantor would still need the consent of the appointed remainder beneficiary, who, like the original beneficiary, has an interest in the trust adverse to the grantor.[91]

83. *Id.* at 528; *see also* discussion *supra* notes 50-58.

84. *Case*, 702 N.Y.S.2d at 767.

85. 209 F.R.D. 309, 316 (N.D.N.Y. 2002).

86. *Id.* at 315; *Spetz*, 737 N.Y.S.2d at 528; 42 U.S.C. § 1396p(d)(3)(B)(i) (2006).

87. *See Spetz*, 737 N.Y.S.2d at 528; *In re Reynolds*, 664 N.E.2d at 1210-11. *See also supra* note 76 and accompanying text.

88. *See* Estate of German v. United States, 7 Cl. Ct. 641, 645 (1985).

89. *Id.* at 644.

90. *Id.*

91. *Id.* The court noted that the children/beneficiary interest was adverse to the grantor and the defendant cited no authority from Maryland or any other jurisdiction that entitled a creditor to the assets of a trust where the access was dependent on the consent of an adverse party. *Id.* The court further noted the Tax Court also failed to produce any such authority,

Creditors have only been permitted to invade an income only trust when the trust provided the grantor was the sole lifetime beneficiary and the balance went to the grantor's estate at his death.[92]

Another distinguishing feature of an Irrevocable Pure Grantor Trust is it can permit the grantor to modify and amend powers of the trustee, appointment of the trustee or trust protector, and the trust's administrative provisions. The grantor's right to remove or appoint a trustee is permissible as long as it is provided for in the trust document.[93] In fact, title vests in a new trustee appointed by the grantor, without regard to transfer by the former trustee, if the trust so provides.[94] The features permitting the grantor elements of control regarding the trust assets, even though he or she has given up access, raises a question as to whether the asset protection is lost because of the grantor's retained *dominion and control*.[95] While there is no substantial case law or treatise discussion on this issue, it is important to address this question. Virtually every case that permits a trust to be invaded for creditors because of the grantor's retained dominion and control did permit it to be invaded on the basis that the trust involved a fraudulent conveyance.[96] In essence, the courts have seen the grantor's retained rights and continued use of trust assets to benefit the grantor as no more than a fraud in the creation and management of the trust.[97]

Similar to the dominion and control argument, some federal courts have applied the corporate "alter ego" doctrine to invalidate trusts.[98] This doctrine identifies the following factors to determine whether the

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absent the creation of reciprocal trusts by husband and wife. *Estate of German*, 7 Cl. Ct. at 644.

92. *See* Weymouth v. Delaware Trust Co., 45 A.2d 427, 428 (Del. Ch. 1946) (relying on established law that despite the irrevocability of the trust, when the grantor is the sole beneficiary, he may compel the trust to be revoked). A properly drawn Irrevocable Pure Grantor Trust will not have the grantor as sole trustee.

93. *See* RESTATEMENT (SECOND) OF TRUSTS §§107(b) cmt. h, 108(b) cmt. F (1959); 33 AM. JUR. 2D *Federal Taxation* ¶ ¶ 2831, 143,604 (2009) (noting that only the amount of rights retained can affect the income and estate tax treatment).

94. *See* RESTATEMENT (SECOND) OF TRUSTS §110 cmt. a.

95. *See* Merric & Gillen, *supra* note 70, at 31. The authors state dominion and control over trust assets does not provide asset protection, but cite no authority for the conclusion; in fact they indicate the case law on dominion and control has not developed. *Id.*

96. *See* Kulp v. Timmons, 944 A.2d 1023, 1029-31 (Del. Ch. 2002). *See also* case discussions cited *infra* notes 126-30.

97. *See Kulp*, 944 A.2d at 1030.

98. *See* Wilshire Credit Corp. v. Karlin, 988 F. Supp. 570, 573-74 (D. Md. 1997) (*citing* William L. Comer Family Equity Trust v. United States, 732 F. Supp. 755, 759 (E.D. Mich. 1990), *aff'd* 966 F.2d 1455 (6th Cir. 1992)); F.P.P. Enter. v. United States, 830 F.2d. 114, 118 (8th Cir. 1987); Loving Saviour Church v. United States, 728 F.2d 1085, 1086 (8th Cir. 1984); United States v. Boucher, 735 F. Supp. 987, 988 (D. Col. 1990)).

corporate veil (trust) should be pierced: (1) the amount of respect given to the corporation (trust) by its shareholders (trustees); (2) the degree of injustice to creditors to uphold the corporation (trust); and (3) the *fraudulent intent* of the incorporators (grantor).[99] Though not exhaustive, other factors include considering whether the corporation is undercapitalized, the maintenance of separate books and finances between the corporation (trust) and the incorporators (grantor), honoring of corporate (trust) formalities and whether the corporation (trust) is a sham.[100] These cases, however, reveal egregious fact patterns that justified penetrating the trust under several of the guidelines cited.[101] Even with egregious fact patterns, however, many courts still favor asset protection and recognize the different legal interests of the trustee and grantor, regardless of the dominion and control by the grantor or beneficiary.[102] A significant distinction between cases that invade irrevocable trusts under a dominion and control, fraudulent conveyance, or alter ego theory is that the grantor's power was used to derive the grantor substantial benefit to the exclusion of the other beneficiaries.[103] In a properly drafted Irrevocable Pure Grantor Trust, the grantor, as trustee, is always managing the trust assets for the benefit of the lifetime principal beneficiaries and the remainder beneficiaries, rather than for him or herself. When creating Irrevocable Pure Grantor Trusts it is critical that the trust prohibit the trustee or any other party from holding authority to distribute principal (or income) to the grantor, and he or she may not retain any right to alter the prohibition.[104] To avoid attack from

99. *William L. Comer Family Equity Trust*, 732 F. Supp. at 759. Note again, the fraudulent conveyance argument is used in the alter ego doctrine. *Id.*

100. *Id.*

101. *See Wilshire Credit Corp.*, 988 F. Supp. at 573-74 (citing *William L. Comer Family Equity Trust*, 732 F. Supp. at 759; *F.P.P. Enter.*, 830 F.2d at 118; *Loving Saviour Church*, 728 F.2d at 1086; *Boucher*, 735 F. Supp. at 988).

102. *See Wilshire Credit Corp.*, 988 F. Supp. at 575-76; *see also* Miller v. Kresser, 34 So. 3d 172, 175-76 (Fla. Dist. Ct. App. 2010).

103. *See* discussion of fraud and insolvency *infra* Section III and *infra* notes 126-30.

104. *See*, *e.g.*, Doherty v. Dir. of the Office of Medicaid, 908 N.E.2d 390, 392 (Mass. App. Ct. 2009); *In re* Sunrise Manor Ctr. for Nursing & Rehab. *ex rel* Gronert v. Novello, 796 N.Y.S.2d 142, 143 (App. Div. 2005) [hereinafter *In re Sunrise*]. In both cases a standard provision in the trust permitted the trustee to terminate the trust if it was no longer practical to administer it, and required it be distributed to the beneficiaries. *See Doherty*, 908 N.E.2d at 391-93; *In re Sunrise*, 796 N.Y.S.2d at 143. The boilerplate provision caused the assets of the trust to be considered available in determining the grantor's eligibility for Medicaid. *See Doherty*, 908 N.E.2d at 391-93; *In re Sunrise*, 796 N.Y.S.2d at 143. While both cases concerned Medicaid eligibility, it would follow that a creditor can make the same argument under section 156 of Restatement (Second) of Trusts, that since the trustee retained the conditional discretionary power to terminate the trust and if exercised, the termination would cause the principal to be distributed to the grantor, then the assets would

creditors, a limited power of appointment with a clearly defined class of appointees should be identified. In addition, the grantor, if trustee, should maintain separate records when conducting trust business and should ensure the funding of the trust does not cause insolvency. The grantor should never mix trust accounts with his or her own and must ensure he or she never takes or uses trust assets other than as specifically provided for by the trust. It also goes without saying that the grantor has a valid reason to create the trust other than to defraud current or future creditors.

The common law is clear that the power retained by a grantor to be trustee, to remove or appoint the trustee, trust protector or to modify the administrative provisions of an irrevocable trust do not subject the trust to the grantor's creditors. Any concern as to whether permitting a grantor a non-general or limited power of appointment is a reason to invalidate an Irrevocable Pure Grantor Trust is unfounded and no legal precedent supports such a position. The issue as to whether the grantor maintains too much dominion and control is by no means established case law. However, even if for arguments sake it were so and to the extent it was, the application of those rules to Irrevocable Pure Grantor Trusts are no different than when planning and funding any irrevocable trust, including a DAPT, CRT, CLT, IOT, GRAT, GRUT, or QPRT. Again, the significant difference with an Irrevocable Pure Grantor Trust is while the grantor retains elements of control, it cannot be exercised to benefit the grantor in anyway. The saying that "pigs get fat and hogs get slaughtered" applies to any attorney who plans, creates, and funds irrevocable trusts. It is critical for attorneys to examine the many legitimate reasons to create an Irrevocable Pure Grantor Trust, review them with the client, and choose the features that best meet the client's goals.[105]

III. USES AND TYPES OF IRREVOCABLE PURE GRANTOR TRUSTS

An Irrevocable Pure Grantor Trust provides asset protection, similar to the goals of non-grantor, defective grantor or even DAPT's, but without their complexity. Irrevocable trusts permit clients to protect their assets from lawsuits, nursing homes and other predators, but protection in any irrevocable trusts requires the client to give up their

be considered available to the grantor's creditors whether or not the trustee exercised that authority.

105. For example, if the attorney is concerned with naming the grantor as sole trustee, the trust could be drafted to have a child beneficiary as a co-trustee as they would have an adverse interest to the grantor.

right to the assets they wish to protect. Any attempt to retain rights, but eliminate those rights to creditors is unsupported by the law.[106] When estate tax avoidance is not a goal, clients have the ability to retain even more rights since there is no concern with pure grantor trust tax treatment. Some of the many reasons to utilize Irrevocable Pure Grantor Trusts include the ability of the grantor to give up the right to their principal, but retain the right to the income it creates. This use is no different from the use of an immediate annuity where an individual transfers money to an insurance company, which in turn, provides a stream of income to the transferor, without permitting access to the principal.[107] Additional reasons to utilize an Irrevocable Pure Grantor Trust, include to prevent the imposition of a gift tax or to ensure a step-up in tax basis to the grantor's beneficiaries at his or her death.[108]

Perhaps the strongest reason to create an Irrevocable Pure Grantor Trust is for general estate planning reasons. An outright transfer of assets to a child subjects it to the child's creditors, bankruptcy, or a spouse in divorce.[109] The death of a child while the grantor is still living, or even after the grantor's death, could result in the asset being owned by unintended beneficiaries. For example, if a child's death was the result of a car accident caused by the child, the assets intended for the child could end up in the hands of the person suing his estate. The same risk occurs even if the accident does not lead to the child's death, or if the child is otherwise subject to lawsuits.[110] Various other estate planning objectives also exist. If a child is disabled, a transfer of assets to them, during life or after death, can disqualify them from any state or federal needs based benefits they are receiving.[111] Tax planning can also play a role. If a child wins the lottery or their personal financial success subjects them to extensive income or estate taxes, a transfer from a parent results in additional taxes being paid by the child.[112] Other reasons to avoid transferring assets to family members include if

106. *See* discussion *supra* Section II; *but see* discussion *infra* Section IV.

107. *See* Michael P. McElroy, 3A HORNER PROBATE PRAC. & ESTATES § 66:1 (2010).

108. *See* I.R.C. § 2503(b) (2006); *see also id.* §§ 1014(a), (e), 1015(a)-(b).

109. *See* RESTATEMENT (SECOND) OF TRUSTS §156 (1959). However, note the child is now the grantor as to the property received.

110. For example, if the child is a doctor or other professional subject to personal liability for his professional acts or if the child is otherwise prone to liability for reasons such as committing torts, divorce or bankruptcy.

111. For example, eligibility for Medicaid Benefits requires applicant's have less than a stated amount of resources. *See* 42 U.S.C § 1396p (2006).

112. The law permits individuals to bypass their children and distribute assets to grandchildren, but the IRS limits the amount that can "skip" children. *See* I.R.C. §§ 2611-13 (relating to generation-skipping tax limitations).

they are a minor, have a drug or alcohol addiction or are not equipped to manage the money in the manner the grantor wishes.[113] Finally, while there may be sentiment against planning to qualify for Medicaid benefits if the need for long term care arises, such planning is a right afforded all Americans.[114] So long as the Medicaid laws are followed, including transfers to irrevocable trusts, eligibility will rightfully occur. This is no different than tax planning, when using trusts with different features that enable a grantor to legitimately avoid tax if the laws are properly followed. Even if the grantor does not have any of these concerns currently, it can change while he or she is living or after death for a spouse that survives.

To accomplish the various goals of individuals, Irrevocable Pure Grantor Trusts come in three distinct versions. The first is an "income only" version. In this trust, the grantor irrevocably gives up the right to the corpus of the trust, but retains the right to income for life or a term of years. The second is a "control only" version wherein the grantor retains powers but irrevocably gives up the right to income and principal from the trust for life. The third version is a "third party" Irrevocable Pure Grantor Trust. In this trust, a third party (usually children or siblings) creates a trust for an individual's lifetime, but the remaining principal reverts back to the third party grantor at the individual's death. The income only version ensures the grantor retains the right to the income from the assets transferred to the trust, but protects the principal. The income retained by the grantor, however is accessible to the grantor's creditors.[115] The primary use of the control only version pertains to individuals who want to protect their assets and the income it produces from unintended beneficiaries or do not want to distribute all of their assets to beneficiaries during life. It is particularly beneficial if the grantor has appreciated assets, since the transfer after death will receive a stepped-up tax basis to the beneficiary.[116] Additionally, the grantor can name principal beneficiaries during his or her lifetime, make distributions in amounts and at times the grantors chooses, and retain a power of appointment to change the beneficiaries, but never back to the grantor. Any distributions from the trust during the grantor's life are, however, subject to the gift tax and carry-over tax basis previously discussed.[117]

113. Although a beneficiary may not have any addictions or disabilities currently, circumstances could occur that they may in the future.

114. *See generally* 42 U.S.C. § 1396p.

115. *See* RESTATEMENT (SECOND) TRUSTS § 156 (1959).

116. *See* I.R.C. §§ 1014(a), 1015(a)-(b).

117. *See id.* §§ 1014(a), 1015(a)-(b), 2503(b).

Similar to the income or control only versions, but with a totally different application, is the third party Irrevocable Pure Grantor Trust. The most common use of the third party version occurs when a child wishes to ensure a parent has the financial support to maintain a lifestyle they otherwise would not be able to or to protect assets a parent may have already transferred to a child, but is concerned the assets can be lost to the child's creditors, divorce, bankruptcy, or other predator. A sibling can also use this version to provide resources for another sibling. Either use ensures the remaining assets revert back to grantor, free from the third party beneficiary's creditors. Unlike the first two versions, this version is usually associated with the life of the third party beneficiary rather than the grantor's life. All of the same rules relating to the tax and asset protection treatment discussed previously apply, but unlike the income or control only versions, the grantor does not retain any right to the trust during the life of the third party beneficiary. While the trust assets are not at risk to the creditors of the third party beneficiary, they can become subject to the liabilities of the grantor if the trust reverts back to the grantor at the beneficiary's death or other terminating event.[118] To avoid this concern, the grantor can, by the terms of the trust, convert it to an income only or control only version at the death of the third party beneficiary and receive the same asset protection for the grantor had the income or control only version been created initially. There are many uses and types of Irrevocable Pure Grantor Trusts and the grantor has extensive options to achieve the result he or she desires.

IV. IRREVOCABLE PURE GRANTOR TRUSTS ARE NOT DOMESTIC ASSET PROTECTION TRUSTS

It is not uncommon for the Irrevocable Pure Grantor Trust to be confused with DAPTs which are notably different.[119] It is well established that an individual cannot create an irrevocable trust and retain rights to it without subjecting the rights retained to his or her creditors.[120] An individual can, however, create a third party irrevocable trust and the grantor's creditors cannot reach the assets unless it was created by a fraudulent conveyance.[121] Generally,

118. *See supra* Section II.

119. *See infra* note 133.

120. *See supra* Section II. *See also* RESTATEMENT (THIRD) OF TRUSTS §§ 58, 60 (2003); RESTATEMENT (SECOND) OF TRUSTS §156; SCOTT & FRATCHER, *supra* note 51, § 156.2; SCOTT ET AL., *supra* note 57, at §§ 15.4, 15.4.3 (5th ed. 2007); GEORGE GLEASON BOGERT ET AL., THE LAW OF TRUSTS & TRUSTEES §§ 223, 227 (3d. ed. 2007).

121. *See* SCOTT ET AL., *supra* note 57, at §15.4.

creditors of a beneficiary of a third party trust are not entitled to income or assets payable to the beneficiary.[122] Common law identifies whether a trust is a spendthrift trust and, if so, then identifies whether it is a support trust or discretionary trust.[123] Virtually all states protect a beneficiary's interest in spendthrift trusts created by a third party, but some states have scaled back the protection from support trusts and, in rare instances, discretionary trusts.[124] Additional concerns to be aware of include ensuring the trust cannot be invaded pursuant to the Bankruptcy Abuse Prevention Act of 2005[125] and avoiding fraudulent conveyances.[126] Extensive analysis has been done on these issues identifying laws that apply regardless of the type of trust being created and as such, no separate analysis is needed when creating Irrevocable Pure Grantor Trusts.[127] It has been stated that trusts similar to Irrevocable Pure Grantor Trusts are subject to the reach of the Bankruptcy court.[128] There is a distinction, however, in bankruptcy decisions that reach the assets in an irrevocable trust, but namely because the transfer to the trust was a fraudulent conveyance, the trust was drafted to permit access by the grantor, or provided discretion to the trustee to make distributions to the grantor.[129] An Irrevocable Pure Grantor Trust, when used properly does not involve a fraudulent

122. *See* RESTATEMENT (THIRD) OF TRUSTS §§ 56-60; RESTATEMENT (SECOND) OF TRUSTS §§ 149-162; *see also* BOGERT ET AL., *supra* note 120, at §§ 193, 227, 228; SCOTT ET AL., *supra* note 57, at §15.3.1.

123. *See supra* note 122. *See also* Alan Newman, *Spendthrift and Discretionary Trusts: Alive and Well Under the Uniform Trust Code*, 40 REAL PROP. PROB. & TR. J. 567, 568-71 (2005); SCOTT ET AL., *supra* note 57, at § 15.3.

124. *See supra* note 122. *See also* SCOTT & FRATCHER, *supra* note 51, at § 187; BOGERT ET AL., *supra* note 120, at §§ 222, 224. *See also* Charles Harris & Tye J. Klooster, *Beneficiary-Controlled Trusts Can Lose Asset Protection*, TRUSTS & ESTATES, December 2006, at 36, 39, 41; Janet Nava Bandera, *Asset Protection: Back to Basics*, 4 J. PRACT. EST. PLAN. 21, 24 (2002); Newman, *supra* note 123, at 568-69. I will not analyze the cases cited under treatises or the referenced article as it is not the subject of this article, but the reader is encouraged to do so for further information.

125. See *generally* Bankr. Abuse Prevention & Consumer Prot. Act of 2005, Pub. L. No. 109-8, *See also* 11 U.S.C. §§ 541, 548 (2006), 119 Stat. 23.

126. *See* Richard W. Nenno & John E. Sullivan, *Planning and Defending Domestic Asset-Protection Trusts*, A.L.I.-A.B.A. COURSE OF STUDY, SR034 ALI-ABA 1825, §§ II(D), III, IV(I)(1-4) (2010). *See also* 11 U.S.C. § 548; Robert T. Danforth, *Rethinking The Law of Creditors' Rights in Trusts*, 53 HASTINGS L.J. 287, 326-33 (2002). *See also infra* notes 129-30.

127. *See generally* Nenno & Sullivan, *supra* note 126; *see* Danforth, *supra* note 126 at 326-33. *See also infra* note 134.

128. *See* Merric & Gillen, *supra* note 70, at 30.

129. *See, e.g.*, *In re* Frangos, 132 B.R. 723 (Bankr. N.D. Ohio 1991). *See also In re* Spenlinhauer, 182 B.R. 361, 365 (Bankr. Me. 1995); *In re* Page, 239 B.R. 755, 767 (Bankr. W.D. Mich. 1999).

conveyance and does not permit the grantor access to the trust under any circumstance.[130]

In direct opposition to the well established common law, Restatement Second and Third of Trusts,[131] and the Uniform Trust Code,[132] twelve states have enacted DAPT statutes that permit a grantor to transfer assets to irrevocable trusts and retain a right to benefit from them through an independent trustee or other third party, but statutorily prohibit access to the grantor's creditors.[133] While the specific state statutory provisions are contrary to common law, they are well recognized and many writings provide public policy and legal positions in support of and against the constitutionality of these statutes.[134] The articles also identify conflicts between tax law, common law, bankruptcy law, the Uniform Trust Code, and the Restatement Second and Third of Trusts with DAPT statutes.[135] This article presents no position on the validity of DAPTs or the potential constitutional challenges to them and leaves such analysis to those who choose to provide it. Instead, it is important to distinguish the Irrevocable Pure Grantor Trust from DAPTs so as to avoid having it confused with or classified as a one. The fundamental difference is Irrevocable Pure Grantor Trusts utilize common law and universally accepted legal principles regarding asset protection for self-settled trusts, whereas DAPTs are based on specific state statutes in direct conflict with common law and universally accepted legal principles by permitting a

130. *See supra* Section II.

131. *See generally* RESTATEMENT (THIRD) OF TRUSTS §§ 61-65; RESTATEMENT (SECOND) OF TRUSTS §§ 331-347; *see also* discussion *supra* Sections II and III.

132. *See generally* UNIF. TRUST CODE § 411 (2000), 7C U.L.A. 497-98 (2006); *see also* discussion *supra* Sections II and III.

133. *See* Nenno & Sullivan, *supra* note 126, § IV(F)(4)(b)(6). Since the publication of the foregoing article, New Hampshire has adopted a similar statute. *See* Qualified Dispositions in Trust Act, N.H. REV. STAT. § 564-D (LexisNexis Supp. 2009).

134. *See* Nenno & Sullivan, *supra* note 126, § IV(F)(4)(b)(6). *See also, e.g.*, Danforth, *supra* note 126, at 312-18; Randall J. Gingiss, *Putting a Stop to "Asset Protection" Trusts*, 51 BAYLOR L. REV. 987, 1008-12 (1999); Karen E. Boxx, *Gray's Ghost—A Conversation About the Onshore Trust*, 85 IOWA L. REV. 1195, 1251-62 (2000); Darsi Newmann Sirknen, *Domestic Asset Protection Trusts: What's the Big Deal?*, 8 TRANSACTIONS: TENN. J. BUS. L. 133, 136-57 (2006); Adam J. Hirsch, *Fear Not the Asset Protection Trust*, 27 CARDOZO L. REV. 2685, 2686 (2006); John K. Eason, *Policy, Logic, and Persuasion in the Evolving Realm of Trust Asset Protection*, 27 CARDOZO L. REV. 2621, 2654-83 (2006); Richard W. Nenno, *Planning with Domestic Asset Protection Trusts: Part I*, 40 REAL PROP. PROB. & TR. J. 263, 271-76 (2005).

135. *See* Nenno & Sullivan, *supra* note 126, § IV(F)(4)(b)(6). *See also, e.g.*, Danforth, *supra* note 126, at 312-18; Gingiss, *supra* note 134, at 1008-12; Boxx, *supra* note 134, at 1251-62; Sirknen, *supra* note 134, at 136-57; Hirsch, *supra* note 134, at 2686; Eason, *supra* note 134 at 2654-83; Nenno, *supra* note 134, at 271-76.

grantor to benefit from a self-settled trust without providing access to his or her creditors.[136]

CONCLUSION

The use of revocable living trusts to avoid probate and irrevocable trusts to protect individuals' assets or avoid taxes has become commonplace.[137] Changes in the estate tax laws and the number of Americans it applies to have significantly diminished the need for non-grantor trusts. The expanded use of trusts to provide for asset management and distribution after an individual's incompetency or death enables them to create a rule book to manage their assets for their benefit or their beneficiaries if they are unable to do it. Features such as allowing the grantor to serve as sole or co-trustee, change the beneficiaries, and modify the trust, traditionally limited to revocable trusts, are now available in irrevocable trusts without adverse consequences.[138]

Americans have experienced a myriad of events over the past ten years that have created a desire to protect what they have. Even when we rebound from these events, the impact will affect the goals of each generation that experienced them. The number of lawsuits filed annually and the cost of long-term care threaten to wipe out individual's lifetime savings. The world has changed significantly and so has the estate planning landscape. The tax treatment of Irrevocable Pure Grantor Trusts provides tax neutrality with no impact on the grantor's taxes and no special tax returns to file.[139] The grantor's ability to protect assets by giving up the right to them, while retaining the income from them and control for beneficiaries, are all desirable features of the Irrevocable Pure Grantor Trust. The ability to provide for the distribution assets to beneficiaries protected from their divorce, bankruptcy, lawsuits, and other predators are added benefits and the flexibility to choose an income only, control only or third-party version of the Irrevocable Pure Grantor Trust allows grantors seeking protection of their assets the ability to qualify for government benefits to pay for a nursing home if needed. Perhaps the greatest significance of the Irrevocable Pure Grantor Trust is the universal agreement by all major legal authorities of the protection provided by its features. The estate planning landscape has changed and the Irrevocable Pure Grantor Trust

136. *See* discussion *supra* Sections II and III; *see also supra* notes 131-35.
137. *See supra* Sections I and II.
138. *See supra* Sections II and III.
139. *See supra* note 37.

provides a whole new opportunity of trust planning satisfactory to Mr. and Mrs. Richards and many other individuals who wish to protect what they have worked for, for the people they care most about, with the least amount of complexity.