

# USING THE LIFETIME SPECIAL POWER OF APPOINTMENT TRUST IN ASSET PROTECTION PLANNING

Presentation to the Estate Planning Section  
of the Utah State Bar

by Mark J. Morrise  
Callister Nebeker & McCullough

January 11, 2011

## I. INTRODUCTION

### A. What Types of Asset Protection Arrangements Are Acceptable?

As an estate planning advisor, this presenter is always on the lookout for new planning tools. In the asset protection area, in general this presenter looks for planning arrangements that:

1. Are based on statute or established case law.
2. Have costs and risks acceptable to clients.
3. Do not involve unethical or illegal conduct on the part of either the client or the attorney. This includes avoidance of any:
  - a. Fraudulent transfers.
    - i. No claims pending or threatened at time of transfer.
    - ii. Client not rendered insolvent by the transfer.
  - b. Concealment of assets.
  - c. Any other type of fraud.

With regard to Point A.3 above, assisting a client in concealing or fraudulently transferring assets can result in attorney liability.<sup>1</sup>

---

<sup>1</sup>E.g., *In re Benson*, 854 P.2d 466 (Or. 1993) (six-month suspension); *In re Carl L. Kenyon and Robert P. Lusk*, 491 S.E.2d 252 (S.C. Sup. Ct. 1997) (ethics violation); *Monastra v. Konica Business Machines*, 43 Cal. App. 4<sup>th</sup> 1704 (1996) (civil conspiracy); *Cadle v. Schultz*, 779 F. Supp. 392 (N. D. Tex. 1991) (civil RICO).

## B. Self-Settled Trusts As an Asset Protection Tool

1. In general, where a settlor creates an irrevocable trust for his or her own benefit (a “self-settled trust”), creditors of the settlor can reach the maximum amount that the trustee can distribute to or for the settlor’s benefit.<sup>2</sup>
2. Until the 1990’s, attempts to use self-settled trusts as an asset protection tool were unsuccessful.<sup>3</sup>
3. Beginning with Alaska in 1997, states began passing laws that provided creditor protection for self-settled trusts.
  - a. The four leading states are Alaska, Delaware, Nevada, and South Dakota.
  - b. Other states include Colorado, Hawaii, Missouri, New Hampshire, Oklahoma, Rhode Island, Missouri, Tennessee, Utah<sup>4</sup> and Wyoming.
  - c. These have become commonly known as “domestic asset protection trusts” (DAPTs).
4. Common characteristics of DAPTs
  - a. Irrevocable.
  - b. Situs of DAPT must be in the state with the DAPT laws.
  - c. Settlor is a beneficiary but should not be the trustee (sometimes called the “investment trustee”).
  - d. In addition to having an investment trustee, a DAPT also requires a trustee (sometimes referred to as the “qualifying trustee”) located in the situs state. In some DAPT states, including Utah, this must be a corporate trustee.
  - e. A Settlor’s transfer of assets to a DAPT is either a “completed” or an “incomplete” gift for gift and estate tax purposes.
    - i. Completed-gift DAPT.

---

<sup>2</sup>U.C.A. § 75-7-505(1)(b); RESTATEMENT (SECOND) OF TRUSTS § 156(2) (1959); see RESTATEMENT (THIRD) OF TRUSTS § 58 & comment *e* (2003).

<sup>3</sup>E.g., *Leach v. Anderson*, 535 P.2d 1241 (Utah 1975).

<sup>4</sup>U.C.A. § 25-6-14.

- (A) Trust assets are outside of Settlor's taxable estate.
- (B) Transfers to DAPT are either sales or taxable gifts.
- ii. Incomplete-gift DAPT.
  - (A) Settlor retain powers (such as a veto power<sup>5</sup> or a testamentary power of appointment<sup>6</sup>) that make a transfer to the trust an incomplete gift for gift tax purposes.
  - (B) Gratuitous transfer to trust is not a taxable gift.
  - (C) Trust assets are included in settlor's taxable estate.
  - (D) Primary benefit of DAPT to settlor is asset protection.
- 5. Costs and risks of DAPT to client.
  - a. Annual fee to corporate trustee in DAPT state ranges between \$1,500 to \$3,000.
  - b. 10-year look-back in bankruptcy allows bankruptcy trustee to include in bankruptcy estate any transfers to DAPT within prior 10 years that were made with actual intent to hinder, delay, or defraud present or future creditors.<sup>7</sup>

### **C. Irrevocable Interest-Only Medicaid Trusts**

- 1. Irrevocable interest-only medicaid trusts ("IOMTs") are explained by Mark Merric and Robert D. Gillen in "Asset Protection for the Middle Class" published in the May 2010 issue of Trusts & Estates magazine.
  - a. Settlor transfers assets to irrevocable trust and retains only a mandatory income interest.
  - b. Any principal distributions are to settlor's children.

---

<sup>5</sup>Treas. Reg. § 25.2511-2(c)

<sup>6</sup>Treas. Reg. § 25.2511-2(b), 2(c).

<sup>7</sup>11 U.S.C. § 548(3).

- c. But (nod, nod, wink, wink<sup>8</sup>), settlor's children could, if they wish, make gifts of such principal to the settlor.
- 2. This presenter does not use IOMTs or recommend them.
- 3. Mention is made here of IOMTs so that later in this presentation, IOMTs, along with DAPTs, can be compared and contrasted with Lifetime Special Power of Appointment Trusts.

**D. Advocates of Lifetime Special Power of Appointment Trusts As an Asset Protection Tool**

- 1. Two recent articles advocate the Lifetime Special Power of Appointment (LSPA) Trust as an asset protection tool.
- 2. First, Alexander Bove, Jr., published an article in the Fall 2010 issue of the ACTEC Journal entitled, "Using the Power of Appointment to Protect Assets – More Power Than You Ever Imagined."
  - a. Mr. Bove is not a newcomer to the topic of powers of appointment.
  - b. His previous articles in this area include:
    - i. "A Creative Strategy for Protecting the Home for Medicaid Purposes," Estate Planning Journal (January 1997).
    - ii. "Exercising Powers of Appointment – A Simple Task or Tricky Business?," Estate Planning Journal (June 2001).
    - iii. "Powers of Appointment: More (Taxwise) Than Meets the Eye," Estate Planning Journal (October 2001).
- 3. Second, this month Lee McCullough III, a solo practitioner in Provo, Utah and an adjunct professor at the J. Reuben Clark School of Law, published an article in the Estate Planning Journal entitled, "Use 'Powers' to Build a Better Asset Protection Trust."
- 4. An earlier article on this same topic is: William R. Culp, Jr. and Mark L. Richardson, "Lifetime Special Powers of Appointment Offer Unique Planning Opportunities," Estate Planning Journal (October 2006).

---

<sup>8</sup>These are Merric and Gillen's words. Cf. M. Python sketch, "Nudge, Nudge, Wink, Wink, Say No More, Say No More."

5. This outline refers to Messrs. Bove, McCullough, Culp, and Richardson collectively as the “LSPA Trust advocates.”

## II. WHAT IS A LIFETIME SPECIAL POWER OF APPOINTMENT TRUST AND HOW DOES IT WORK FOR ASSET PROTECTION PURPOSES?

### A. Definitions of Some Terms

1. A **power of appointment** is “simply the power to dispose of property.”<sup>9</sup> More precisely, “A power of appointment is a power that enables the [power holder], acting in a nonfiduciary capacity, to designate recipients of beneficial ownership interests in the appointive property.”<sup>10</sup>
2. A **general power of appointment** (GPA) includes the right to appoint the subject property to the power holder, the power holder’s estate, the power holder’s creditors, or the creditors of the power holder’s estate.<sup>11</sup>
3. A **special power of appointment** (SPA), also known as a limited or nongeneral power of appointment, is any power of appointment that is not a general power of appointment.
4. The **donor** is the person who creates or reserves the power.
5. The **power holder**, also known as the “donee,” is the person on whom the power is conferred or in whom the power is reserved.
6. The **permissible appointees** are the persons for whose benefit the power may be exercised.

---

<sup>9</sup>Alexander Bove, Jr., “Using the Power of Appointment to Protect Assets – More Power Than You Ever Imagined,” 36 ACTEC Journal 333, 334 (Fall 2010) [hereafter referred to as the “Bove article”], citing RESTATEMENT (SECOND) OF PROPERTY (Donative Transfers) § 11.1 (1986).

<sup>10</sup>RESTATEMENT (THIRD) OF PROPERTY (Wills & Donative Transfers) § 17.1 (T.D. No. 5, 2006).

<sup>11</sup>RESTATEMENT (THIRD) OF PROPERTY (Wills & Donative Transfers) § 17.3 (T.D. No. 5, 2006); Internal Revenue Code §§ 2041(b)(1), 2514(c). In the remainder of this outline, all statutory references are to the Internal Revenue Code except as otherwise noted.

7. A power of appointment that can be exercised during the power holder's life is a **lifetime** or inter vivos power of appointment. A power of appointment that can be exercised at death is a **testamentary** power of appointment.

EXAMPLE #1: At his death, John Smith's revocable trust divides into marital and family (i.e., bypass or credit shelter) trusts. Under the terms of the family trust, John [as *donor*] grants to his wife Mary [as *power holder* or *donee*] the power at her death to appoint the remaining assets of the family trust to any of their descendants [the *permissible appointees*] as she in her sole discretion may choose. John has granted a testamentary SPA to Mary.

## **B. Estate and Gift Tax Treatment of Powers of Appointment**

1. Estate tax: A decedent's gross estate includes the value of all property over which the decedent possessed a GPA at death. § 2041(a)(2). Mere possession of the GPA causes estate inclusion, regardless of whether it was actually exercised.
2. Gift tax: The exercise or release of a GPA during life is a transfer of property (§ 2514(b)) which consequently results in a taxable gift.
  - a. But a qualified disclaimer of a GPA under § 2518 is not a "release" of that power.
  - b. In general, the lapse of a GPA is treated as a "release" of the power. There are exceptions, such as the lapse the so-called five and five power,<sup>12</sup> which are beyond the scope of this outline.
  - c. A power is not treated as a GPA if it is limited by an ascertainable standard such as "health, education, support and maintenance."<sup>13</sup>
3. In contrast to a GPA, possession of an SPA at death does not cause estate inclusion nor does its exercise or release during life result in a taxable transfer.

EXAMPLE #2: In Example #1, John Smith's grant of a testamentary SPA to Mary Smith will not cause inclusion of the family trust's assets in Mary's estate at her death.

4. Powers of appointment present many tax traps for the unwary. For example, if a power can be exercised to discharge a power holder's legal obligation of support,

---

<sup>12</sup>Section 2514(e).

<sup>13</sup>Treas. Reg. § 20.2041-1(c)(2); Treas. Reg. § 25.2541-1(c)(2).

the power will be deemed to be exercisable in favor of the power holder's creditors and therefore it will be treated as a GPA for estate tax purposes.<sup>14</sup>

### C. What Is a Lifetime Special Power of Appointment Trust?

1. It is similar to a DAPT in that:
  - a. It is an irrevocable trust.
  - b. It can be either a completed gift or incomplete gift trust.
2. Unlike a DAPT, it does not have to be sited in a DAPT state.
3. A lifetime special power of appointment (LSPA) is granted to someone, preferably not a trustee so that the power is not subject to fiduciary obligations.<sup>15</sup>
4. The LSPA is written broadly enough to permit the power holder to appoint the trust assets back to the settlor/donor, e.g., "[Power holder] has the power to appoint the assets of this trust to anyone except [power holder], [power holder]'s estate, [power holder]'s creditors, or the creditors of [power holder]'s estate."

EXAMPLE #3: "Michael creates a [lifetime] special power of appointment trust naming his friend as the trustee. Michael names his spouse and children as the beneficiaries, but he does not include himself as a potential beneficiary. He gives his friend the . . . power to withhold distributions or to sprinkle distributions among the beneficiaries as he determines in his sole and absolute discretion. Michael also gives his friend a [lifetime] special power of appointment to appoint assets to any person other than himself, his estate, or the creditors of himself or his estate. Michael funds his [lifetime] special power of appointment trust at a time and in a manner that is not considered a fraudulent transfer."<sup>16</sup>

EXAMPLE #4: "[A] settlor establish[es] an income-only trust for his own benefit, giving another party, say, one of his children, a [lifetime] special power of appointment in favor of the settlor's spouse and issue (other than the powerholder). If the trust is attacked (or about to be) by a creditor, the child could exercise her power (reserving the right to revoke the exercise) and appoint the

---

<sup>14</sup>Treas. Reg. § 20.2041-1(c)(1); Rev. Ruling 79-154.

<sup>15</sup>A power of appointment that runs with the office of trustee is strongly presumed to be a fiduciary power. RESTATEMENT (THIRD) OF TRUSTS § 50, general comment *a* (2003).

<sup>16</sup>Lee McCullough III, "Use 'Powers' to Build a Better Asset Protection Trust," Estate Planning Journal (January 2011) [hereafter referred to as the "McCullough article"]

trust property to a new trust for the benefit of the settlor's spouse while she remains a spouse. When the coast became clear and the litigation against the settlor is resolved, the child could reexercise her power and appoint the property back to the original trust for the benefit of the settlor. Meanwhile, the income from the 'new' trust could be paid out to the settlor's spouse, presumably offering some benefit to the settlor. . . . To make matters more difficult for the settlor's creditors, the new trust could be settled in another state."<sup>17</sup>

#### **D. How Does an LSPA Trust Work for Asset Protection Purposes?**

1. A lifetime GPA would give the power holder's creditors rights against the assets subject to the GPA.<sup>18</sup>
2. In contrast, a lifetime SPA gives a power holder's creditors no rights in the LSPA Trust assets.<sup>19</sup>
  - a. A special power of appointment is not considered an interest in property.<sup>20</sup>
  - b. Consequently, a court cannot force the power holder to exercise the LSPA.<sup>21</sup>
  - c. If the power holder were to file bankruptcy, under the Bankruptcy Code assets subject to a special power of appointment are not included in the bankruptcy debtor's estate.<sup>22</sup>
3. Because the donor of the LSPA parts with dominion and control of the LSPA Trust assets, those assets are also protected from donor's creditors.
  - a. The initial transfer must not be fraudulent.

---

<sup>17</sup>Bove article, supra note 9, at 336.

<sup>18</sup>RESTATEMENT (SECOND) OF PROPERTY (Donative Transfers) § 13.5, comment *a* (1986).

<sup>19</sup>RESTATEMENT (THIRD) OF PROPERTY (Wills & Donative Transfers) § 22.1 (T. D. No. 5 2006); RESTATEMENT (SECOND) OF PROPERTY (Donative Transfers) § 13.6 (1986).

<sup>20</sup>RESTATEMENT (SECOND) OF PROPERTY (Donative Transfers) § 13.6, comment *b* (1986); see RESTATEMENT (THIRD) OF TRUSTS § 56, comment *b* (2003).

<sup>21</sup>*In re Hicks*, 22 B.R. 243 (D. Ga. 1982).

<sup>22</sup>11 U.S.C. § 541(b)(1).

- b. For purposes of the fraudulent transfer act, the period of limitations begins when initial transfer is made, not when power holder subsequently exercises the SPA.<sup>23</sup>

EXAMPLE #5: Same facts as Example #4. If the trust is attacked by settlor's creditors, the child exercises her power (reserving the right to revoke the exercise) and appoints the trust property to a new trust for the benefit of the settlor's spouse while she remains a spouse. With respect to whether the settlor's original transfer to the trust was fraudulent, the relevant date is the settlor's transfer to the trust and not the child's subsequent moving of the assets out of the creditor's reach by exercise of the special power. "Unless the exercise was made or attempted within the period of limitations that applied to the settlor's original transfer, there would be no basis for a court to interfere with the exercise or to hold the transfer fraudulent."<sup>24</sup>

**E. Will a Pre-Existing Understanding Between the Donor and the Power-Holder Make a Difference?**

- 1. The key element of an LSPA Trust is that the LSPA must be written broadly enough to permit the power holder to appoint the assets of the LSPA Trust back to the settlor/donor. Does it matter whether a pre-existing understanding exists between the donor and the power holder regarding the power holder's exercise of the LSPA?
  - a. The existence of such a pre-existing understanding cannot be presumed from the mere grant of the LSPA.<sup>25</sup>

EXAMPLE #6: "[A] gift to a child, without more, should not be considered a gift with a retained interest by the parent, even though the child can give the property back to the parent or anyone else, if the child sees fit. Similarly, it would seem that a gift in trust for the benefit of a child, even if the child is provided with an [LSPA] with the ability to

---

<sup>23</sup>RESTATEMENT (SECOND) OF PROPERTY, Part V, introductory note: The "Relation Back" Doctrine (1986).

<sup>24</sup>Bove article, supra note 9, at 341.

<sup>25</sup>"Generally, there is no retention of a right or power regarding the enjoyment of the property transferred merely because a person—such as the spouse of the Settlor—tends to follow the Settlor's wishes." William R. Culp, Jr. and Mark L. Richardson, "Lifetime Special Powers of Appointment Offer Unique Planning Opportunities," Estate Planning Journal (October 2006) [hereafter referred to as the Culp/Richardson article], citing Treas. Regs. § 20.2037-(1)(c)(1) and 20.2037-(1)(c)(2).

appoint the trust assets to the Settlor, without more, should not create a retained interest by the Settlor.”<sup>26</sup>

- b. If, however, such a pre-existing understanding does exist, a creditor might argue that the power holder is acting as the donor’s agent or that the arrangement is a disguised self-settled trust.
2. One of the LSPA Trust advocates, Bove, does not address in his article the effect of a pre-existing understanding between the donor and power holder.
  3. The other LSPA Trust advocates believe that there cannot be any express or implied understanding to appoint the LSPA Trust assets to the settlor because the existence of such an understanding would allow a creditor of the settlor to argue that the settlor did not part with dominion and control of the LSPA Trust assets and would allow the IRS to argue that the trust assets should be included in the settlor’s estate under §§ 2036 – 2038.<sup>27</sup> Culp and Richardson suggest ways in which a creditor or the IRS might attempt to prove the existence of such an understanding:

“It may be possible for the IRS or a creditor to establish that there is an implied agreement for the powerholder to appoint the trust assets to the Settlor in the right circumstances. For instance, if the Settlor transferred all his assets to an [LSPA] Trust, this may be sufficient to imply an agreement to exercise the [LSPA] in favor of the Settlor, especially if the powerholder periodically appointed assets to the Settlor and no distributions were made to any other party. Several recent family limited partnership (‘FLP’) cases have dealt with the issue of whether there was an implied agreement to support a deceased partner using the FLP assets contributed by that partner.” [Footnotes omitted.]

4. In support of the above quotation, Culp and Richardson cite the following authorities:
  - a. Treas. Reg. § 20.2036-1(c)(1)(i): “An interest or right is treated as having been retained or reserved if at the time of the transfer there was an understanding, express or implied, that the interest or right would later be conferred.”
  - b. In *Estate of Paxton v. Commissioner*, 86 TC 785, the taxpayer and his wife transferred almost all of their property, including their residence, to

---

<sup>26</sup>Culp/Richardson article, supra note 25.

<sup>27</sup>McCullough article, supra note 16, at n. 24; Culp/Richardson article, supra note 25. For the text of §§ 2036(a) and 2038(a), see **Addendum A**.

two irrevocable trusts in exchange for certificates of interest representing “units” in the trust. The primary trustee, who was the couple’s oldest son, had broad discretion to make non pro rata distributions (not in proportion to the number units represented by the certificates of interest). The taxpayer had another source of income and received only a few minimal distributions from the trust during his life. Nevertheless, when the taxpayer died, the IRS brought an action asserting that the trust assets were includible in the decedent’s gross estate.

The Tax Court held that an express or implied understanding existed between the decedent and his trustee/son that the decedent would receive distributions from the trust if and when he requested them. Such an understanding need not be legally enforceable and could be inferred from “the circumstances of the transfer and the manner in which the transferred property is used.” 86 TC 785, 810. Although the taxpayer had received only a few minimal distributions from the trust during his life, after his death his surviving wife received more substantial distributions. And, in any event, “continuous receipt of substantial amounts of trust income is not necessary to support the finding of a prearrangement under section 2036(a)(1).” *Id.* at 811-812. Because of the prearrangement between the decedent and his trustee/son, the assets the decedent transferred to the trust were includible in the his gross estate under § 2036(a)(1) because he had retained “possession or enjoyment” of those assets. *Id.* at 814.

- c. In *Estate of Skinner v. United States*, 316 F.2d 517, 11 AFTR 2d 1855 (3<sup>rd</sup> Cir. 1963), the taxpayer created an irrevocable trust naming herself and her brother’s children as discretionary income beneficiaries. During her life, the taxpayer received all the income from the trust. The issue presented by the case was whether the decedent retained for her life the enjoyment of the trust assets. The Third Circuit upheld the district court’s determination that when the taxpayer created the trust, a “prearrangement” existed between the taxpayer and her trustees that the trustees’ discretion would be exercised exclusively in favor of the taxpayer for her life. A fact relied upon by the appeals court was that the taxpayer actually did receive the income for the trust for life.
- d. In *Turner v. Commissioner*, 382 F.3d 367, 94 AFTR 2d 2004-5764 (3<sup>rd</sup> Cir. 2004), a 95-year old taxpayer transferred 95% of his assets to a family limited partnership. Although he had no legal right to withdraw any of the partnership assets, the general partners testified that they “would not have refused” a request by the decedent for a distribution from the partnership. The appeals court upheld the lower court’s determination that, notwithstanding the formal transfer of title to the decedent’s property, the decedent’s relationship to his assets had not changed, and therefore they were includible in his estate under § 2036(a)(1).

- e. Although the cases just discussed are all tax cases, the same general principles apply in creditor protection cases. See Spero, ASSET PROTECTION: LEGAL PLANNING, STRATEGIES AND FORMS, ¶13.10[3], “Retained Limited Powers” (Warren Gorham & Lamont 2001).
5. Similar authorities relating to DAPTs.
- a. In PLR 9837007, the Service ruled that a transfer of property to a self-settled trust with discretionary distributions of income and principal to the grantor and grantor’s descendants was a completed gift for federal gift tax purposes. The ruling was based, however, on the representation that no express or implied agreement existed between the grantor and the trustee as to how trustee would exercise its sole and absolute discretion to distribute income and principal among the beneficiaries.
  - b. In PLR 200944002, the Service likewise ruled that assets of a self-settled trust with discretionary distributions of income and principal to the grantor, grantor’s spouse, and grantor’s descendants would not be included in the grantor’s estate, despite grantor’s power, exercisable in a nonfiduciary capacity to acquire property held in the trust by substituting other property of an equivalent value. The Service declined to rule, however, on whether an understanding or pre-existing arrangement between the grantor and the trustee regarding the trustee’s exercise of its discretion to distribute income and principal would cause estate inclusion under § 2036.
  - c. See also Rev. Ruling 2004-64, in which the Service ruled that where a trust was taxed a grantor trust, the grantor’s payment of income tax would not be treated as an indirect gift to the trust beneficiaries. The Service also ruled that a discretionary tax reimbursement clause, by itself, would not cause the trust’s assets to be included in the grantor’s estate, but went on to state that estate inclusion might occur if an understanding or pre-existing arrangement existed between the grantor and the trustee regarding the trustee’s exercise of this discretion.

## **F. Variations on the LSPA Trust Concept**

The LSPA Trust advocates offer numerous variations on the LSPA Trust concept, including the following:

- 1. Type of trust in which LSPA is used.
  - a. Trust for others (non self-settled); LSPA can be used to appoint assets back to settlor.

- b. Self-settled trust; LSPA can be used to appoint assets away from settlor's creditors.
  - i. DAPT.
  - ii. Non-DAPT income-only trust.
- 2. How trust instrument grants LSPA.
  - a. Immediately upon execution.
  - b. Indirectly; trust protector has power to grant LSPA.
  - c. Hybrid; trust instrument grants immediate TSPA to a limited class, and trust protector has power to add LSPA to a broad class.
- 3. Who trust instrument names as power holder.
  - a. Spouse, child, or third party.
  - b. More than one power holder (joint powers).
  - c. Possibility that power holder(s) can be removed or replaced by trust protector.
- 4. When trust agreement makes LSPA exercisable.
  - a. Anytime.
  - b. Only after a specific event such as death of a spouse or divorce.

EXAMPLE #7: Settlor creates an irrevocable trust for the benefit of the settlor's spouse and children. The trust grants an LSPA to a child, but the LSPA cannot be exercised unless a divorce occurs or the settlor's spouse dies. Presumably, during settlor's marriage to settlor's spouse, distributions to the spouse will also benefit settlor. In the event of a divorce or the spouse's death, the power holder could exercise the LSPA to appoint the trust's assets back to the settlor.

- 5. How trust agreement makes LSPA exercisable.
  - a. No conditions.
  - b. Requires consent of trust protector or third party named by donor.

- c. Alternatively, trust protector may have veto power over exercise.
- 6. Who are permissible appointees under trust agreement?
  - a. Broad class: anyone except power holder, power holder's estate, power holder's creditors, or the creditors of power holder's estate.
  - b. Narrow class, such as donor's descendants.
  - c. Narrow class that can be expanded by trust protector.
- 7. If permissible appointees are broad, in whose favor will LSPA be exercised?
  - a. Settlor / donor.
  - b. Irrevocable trust over which Settlor has retained TSPA (avoids taxable gift upon exercise).
  - c. Irrevocable trust with its situs in another, possibly DAPT, state.
- 8. Manner in which LSPA is exercised.
  - a. Trust property is appointed outright.
  - b. Power holder retains right to revoke appointment and get the property back.
- 9. Manner in which LSPA Trust is funded
  - a. Non-voting interests in an LLC or corporation; voting interests are held in a separate irrevocable trust.

### **III. HOW DOES A LIFETIME SPECIAL POWER OF APPOINTMENT TRUST COMPARE WITH OTHER ASSET PROTECTION ARRANGEMENTS?**

#### **A. Comparable Asset Protection Arrangements.**

It may be useful to compare the LSPA Trust to:

- 1. An outright transfer of an asset to "someone else with the expectation that the recipient will make the assets available to the donor, if needed, or will transfer the assets back to the donor at an appropriate time. This creditor protection technique is commonly used by a physician who transfers assets to his spouse to protect the

assets from malpractice claims. The technique is also used by the elderly who transfer assets to their children so that they can qualify for Medicaid benefits.”<sup>28</sup>

2. Domestic asset protection trusts (DAPTs)
3. Irrevocable income-only medicaid trusts (IIOMTs)

## **B. Areas of Comparison**

Some areas where these asset protection arrangements can be compared include:

1. Does the asset protection arrangement have a reliable legal foundation?
  - a. Is it based on a statute?
  - b. Is it supported by well-developed case law?
  - c. Is it favored under Utah public policy? In this regard, Utah public policy favors DAPTs because of Utah’s own statute in this area.
2. Does the client have enforceable rights under the asset protection arrangement?
  - a. Is the person with power to “send” (transfer, distribute, or appoint) the asset back to the client under a fiduciary duty with regard to the asset? A trustee, of course, is under a fiduciary duty, whereas a mere transferee of the asset or a power holder (unless the power holder is also a trustee) is under no such duty.
  - b. Does the client have an enforceable right to have the asset “sent” back via a transfer by the transferee, distribution by a trustee, or appointment by a power holder? The answer is “no” in all cases, except where the client reserves a mandatory income interest.
  - c. Is it possible for someone, such as a trust protector, to remove or replace the trustee or power holder? The answer is “maybe,” because it will depend on how the trust agreement is drafted.
3. What requirements and costs does the asset protection arrangement impose on the client? Note that in many clients’ minds the deciding factor is costs, which is one reason why some people will engage in the outright transfer arrangement even though it is the weakest from an asset protection standpoint.

---

<sup>28</sup>Culp/Richardson article, supra note 25.

- a. Is the client required to retain sufficient assets outside of the trust or transfer for living expenses and reasonably anticipated debts? The answer is “yes” in all cases.
  - b. Is the situs of the trust required to be in a DAPT state with a trustee in that state?
  - c. Are corporate trustee fees required?
4. Does the asset protection arrangement create opportunities for an attacking creditor to investigate the arrangement?
- a. If the client is asked, “Are you the beneficiary of a trust,” will the answer be “yes”? LSPA Trust advocates point to this factor as an advantage of an LSPA Trust over a DAPT because a client who is merely a permissible appointee of an LSPA Trust and not a trust beneficiary can truthfully answer “no” to this question.
  - b. If the client has a pre-existing understanding or agreement with the transferee regarding return of the assets, with the trustee regarding distributions, with a power holder regarding appointment of trust assets back to the client, or with the client’s children regarding gifts back to the client, will the client be required to disclose this understanding? The answer is “yes” in all cases.
  - c. Are regular transfers back to the client by the transferee, distributions to the client by a trustee, appointments of property back to the client by a power holder, or gifts to the client by the client’s children relevant in determining whether the client failed to relinquish dominion and control over the transferred asset? Again, the answer is “yes” in all cases.
5. Does the asset protection arrangement create tax risks for the client?
- a. Will a transfer, distribution, or appointment of the asset back to the client be a taxable gift? If the asset protection arrangement is an outright transfer, the answer is “yes,” which may be a significant disadvantage of that approach.
  - b. For trusts, will the arrangement cause the trust’s income to be taxed back to the settlor? For DAPTs, the answer to this question is “yes” because of § 676.

For LSPA Trusts, there are different scenarios under which grantor trust status could be triggered. For example, if the grantor’s spouse is the power holder, the spouse’s power to control beneficial enjoyment is

treated as being held by the grantor,<sup>29</sup> and therefore under § 674(a) the trust income would be taxable to the grantor.

If the LSPA is held by a trustee who is a related or subordinate party subservient to the grantor's wishes, in certain cases the same result can occur.<sup>30</sup>

Furthermore, if the power holder is a "non adverse" party, a broad power to appoint the assets to non-beneficiaries could be treated as a power to add beneficiaries under § 674(b), (c), and (d), which can trigger grantor trust status as to the settlor.<sup>31</sup> If, however, the power holder is a trust beneficiary and therefore an adverse party, that may not trigger grantor trust status.<sup>32</sup>

- c. Will the transfer by the trustee or an appointment of property by the power holder to someone other than the settlor/donor be a taxable gift? For an incomplete gift trust (either DAPT or LSPA Trust), the answer is "yes" because such a transfer completes the gift.

As to an LSPA trust, the answer is also "yes" if the power holder has a mandatory income interest in the trust. For example, in *Estate of Register*, 83 TC 1 (1984), the taxpayer was entitled to all of the trust's income payable annually and also had an LSPA to appoint the trust's principal to her son or his issue. The taxpayer exercised her LSPA and appointed all of the trust's principal to a trust for the benefit of her son and his issue. The court ruled that, pursuant to Treas. Reg. 25.2514-1(b)(2), the taxpayer had made a taxable gift of her life income interest in the trust.

- d. Does the arrangement create a risk that the transferred or contributed assets will be included in the client's estate under §§ 2036 or 2038?

---

<sup>29</sup>Section 672(e).

<sup>30</sup>See § 674(c).

<sup>31</sup>Section 674(a); Treas. Reg. § 1.674(d)-2(b). "For example, take the case where a broad special lifetime power is granted to, say, the donor's brother, over a trust for the benefit of the donor's children. Because this arrangement does not fall under any of the exceptions to Section 674, the donor will be taxed on all income from the trust, despite the fact that (1) he has no direct or indirect control over the beneficial enjoyment of the trust and (2) he made a completed gift when he transferred property to the trust." Bove article, supra note 9, at 350-351.

<sup>32</sup>Treas. Reg. § 1.674(d)-2(b).

- e. Does the arrangement create a risk that the transferred or contributed asset will be included in the estate of the transferee, trustee, or power holder?

As to an LSPA Trust, there are some ways this might occur. First, if the power holder is the settlor's child and has a broad LSPA or even a narrow LSPA limited to settlor's descendants, could the fact that the power holder could appoint the trust assets to his or her own children cause the LSPA to be treated as a LGPA, thus causing inclusion of the trust assets in the power holder's estate? See Point II. B.4 above.

Another way in which the LSPA Trust assets might be included in the power holder's estate would be if there were two different trusts in which the power holders had reciprocal powers of appointment, e.g., where they could appoint the trust assets to one another. In such a case, "the IRS will uncross the trusts and will take the position that each beneficiary will be considered to hold a general power of appointment over the trust of which he or she is a beneficiary. See Ltr. Ruls. 9235025 and 9451049. A reciprocal [LSPA] could arise if two beneficiaries are each given a presently exercisable [LSPA] to appoint the same property. In such an event, each powerholder could agree with the other powerholder to appoint to the other."<sup>33</sup>

A third way in which the LSPA Trust assets might be included in the power holder's estate would be if the power holder falls within the so-called "Delaware tax trap," which occurs when a special power of appointment is exercised to create a new special power exercisable without regard to the date of creation of the first power.<sup>34</sup>

6. Does the asset protection arrangement create risks that will allow creditors to attach the transferred or contributed asset?
- a. Could a pre-existing understanding or agreement with the transferee, trustee, or power holder regarding "sending" the asset back to the client subject the asset to the claims of the client's creditors? The answer is "yes" in all cases.
- b. Is the asset subject to the creditors' claims of the transferee, trustee, power holder, or child?

---

<sup>33</sup>Culp/Richardson article, supra note 25, at n.33.

<sup>34</sup>See § 2041(a)(3).

7. Finally, does the asset protection arrangement create the “non-creditor” risk of the asset not being “sent” back to the client?

### C. **Comparison Charts**

Two charts based on the foregoing questions are attached to this outline as **Addenda B** and **C**.

## **IV. ARE THE RISKS AND COSTS OF A LIFETIME SPECIAL POWER OF APPOINTMENT TRUST ACCEPTABLE TO CLIENTS?**

### A. **Words of Caution**

With regard to the risks inherent in an LSPA Trust, two of the LSPA Trust advocates, Culp and Richardson, offer these words of caution:

“While an [LSPA] is a powerful and flexible planning tool, it should be used with caution because its use can have unintended tax and non-tax consequences. From a non-tax standpoint, because an [LSPA] gives the powerholder the presently exercisable power to decide who will own trust property, the grant and scope of this authority should be considered carefully. An [LSPA] requires a thoughtful selection of the powerholder and the potential class of appointees plus a thorough analysis of state law. From a tax standpoint, the grant and exercise of an [LSPA] can trigger income, gift, estate, and generation-skipping transfer (‘GST’) tax consequences.”<sup>35</sup>

### B. **Factors to Consider**

1. Is the client willing to give up control?
2. Does the client have confidence in the selected power holder?

Again, Culp and Richardson recommend caution:

“Because the powerholder of an [LSPA] has the authority to appoint trust property among the designated class of appointees without fiduciary constraints, the identity of the powerholder is an important consideration. A trustee owes a fiduciary duty to the beneficiaries. In contrast, the powerholder of an [LSPA] generally does not owe a fiduciary duty to the beneficiaries. This gives the powerholder greater flexibility in exercising the [LSPA] but also means that careful selection of the powerholder is crucial. In choosing a person to hold the [LSPA], the Settlor will generally want to select someone who may be willing to

---

<sup>35</sup>Culp/Richardson article, supra note 25.

appoint assets to or for the benefit of the Settlor, if desired, or away from the Settlor's creditors if the Settlor is a beneficiary of a self-settled trust.”<sup>36</sup>

3. Will the LSPA be subject to appropriate safeguards?
4. Are the tax risks acceptable?
5. Are the creditor risks acceptable?

## V. CONCLUSION

“An [LSPA] is a complex estate planning device that can provide flexibility to an irrevocable trust. An [LSPA] Trust can provide unique creditor protection benefits but an [LSPA] should not be included in an irrevocable trust unless the planner carefully considers both the tax and non-tax implications.”<sup>37</sup>

---

<sup>36</sup>Id.

<sup>37</sup>Id.

## **ADDENDUM A**

### **Internal Revenue Code Sections 2036(a) and 2038(a)**

#### **Section 2036. Transfers with retained life estate.**

(a) General rule.

The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

- (1) the possession or enjoyment of, or the right to the income from, the property, or
- (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

#### **Section 2038. Revocable transfers.**

(a) In general. The value of the gross estate shall include the value of all property—

- (1) To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death.

## ADDENDUM B

### Comparison of LSPA Trust with Other Asset Protection Arrangements

	Outright Transfer	DAPT	LSPA Trust	IIOMT
<b>Has a Reliable Legal Foundation?</b>				
Based on statute?	No	Yes	No	No
Supported by well-developed case law?	No	No	No	No
Favored under Utah public policy?	No	Yes	No	No
<b>Client Has Enforceable Rights?</b>				
Fiduciary duty owed to client?	No	Yes	No, unless PH* is trustee	Y/N
Client has enforceable right to transfer back?	No	No	No	Y/N
Power to remove or replace trustee/PH*?	n/a	Maybe	Maybe	Maybe
<b>Imposes Requirements and Costs?</b>				
Retain sufficient assets outside trust/transfer for living expenses and anticipated debts?	Yes	Yes	Yes	Yes
Trust situs must be in a DAPT state with a trustee in that state?	n/a	Yes	No	No
Corporate trustee fees required?	n/a	Yes - some states	No	No
<b>Investigation Opportunities for Creditors?</b>				
Client must disclose beneficiary status?	n/a	Yes	No	Yes
Must disclose pre-existing understanding?	Yes	Yes	Yes	Yes
Regular distributions to client relevant?	Yes	Yes	Yes	Y/N
<b>Creates Tax Risks?</b>				
Transfer back to client a taxable gift?	Yes	No	No	Yes
Causes trust income to be taxed to settlor?	n/a	Yes	Maybe	n/a
Transfer by trustee/PH* a taxable gift?	n/a	Maybe	Maybe	No
Inclusion in settlor's estate under § 2036?	Maybe	Maybe	Maybe	Maybe
Inclusion in estate of transferee/trustee/PH*?	Yes	No	Maybe	No
<b>Creates Creditor Risk?</b>				
Pre-existing understanding could subject property to claims of client's creditors?	Yes	Maybe	Yes	Yes
Subject to claims of donee's creditors?	Yes	No	No	Yes
<b>Creates Non-Creditor Risk?</b>				
Trustee/PH* could refuse to distribute/appoint property?	Yes	Yes	Yes	Yes

\*Power Holder

## ADDENDUM C

### Comparison of LSPA Trust with Other Asset Protection Arrangements

	Outright Transfer	DAPT	LSPA Trust	IIOMT
<b>Has a Reliable Legal Foundation?</b>				
Based on statute?	–	+	–	–
Supported by well-developed case law?	–	–	–	–
Favored under Utah public policy?	–	+	–	–
<b>Client Has Enforceable Rights?</b>				
Fiduciary duty owed to client?	–	+	–	+/-
Client has enforceable right to transfer back?	–	–	–	+/-
Power to remove or replace trustee/PH?	n/a	?	?	?
<b>Imposes Requirements and Costs?</b>				
Retain sufficient assets outside trust/transfer for living expenses and anticipated debts?	–	–	–	–
Trust situs must be in a DAPT state with a trustee in that state?	n/a	–	+	+
Corporate trustee fees required?	n/a	–	+	+
<b>Investigation Opportunities for Creditors?</b>				
Client must disclose beneficiary status?	n/a	–	+	–
Must disclose pre-existing understanding?	–	–	–	–
Regular distributions to client relevant?	–	–	–	+/-
<b>Creates Tax Risks?</b>				
Transfer back to client a taxable gift?	–	+	+	–
Causes trust income to be taxed to settlor?	n/a		?	n/a
Transfer by trustee/PH* a taxable gift?	n/a	?	?	+
Inclusion in settlor's estate under § 2036?	?	?	?	?
Inclusion in estate of transferee/trustee/PH*?	–	+	?	+
<b>Creates Creditor Risk?</b>				
Pre-existing understanding could subject property to claims of client's creditors?	–	?	–	–
Subject to claims of donee's creditors?	–	+	+	–
<b>Creates Non-Creditor Risk?</b>				
Tee/PH* could refuse to appoint property?	–	n/a	–	–
<b>TOTAL PLUSES</b>	<b>0</b>	<b>6</b>	<b>5</b>	<b>4</b>

\*Power Holder