USA

Wilderness no more: Alaska as the new 'offshore' trust jurisdiction

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In the last two years, Alaska has taken steps to become the pre-eminent US jurisdiction for trust creation and administration. Although some call it the last great wilderness area, Alaska is positioning itself as the newest and most sophisticated 'offshore' trust jurisdiction for wealthy US citizens and non-US persons holding substantial US real property or stock.

Alaska has made two sweeping reforms to its trust laws. First, it has departed from the venerated (if misinterpreted) 'rule against perpetuities,' with origins in the seventeenth century *Duke of Norfolk's Case* (1681) 3 Ch Cas 1 at 36, 22 Eng Rep 931. Under Alaska law, most trusts may now last in perpetuity. Second, even where a grantor retains a discretionary interest in a self-settled trust, because Alaska has changed its rules regarding the ability of creditors to attach such an interest, the trust assets likely will be excluded from the grantor's estate for US Federal estate tax purposes. Most surprising to estate planning professionals in jurisdictions such as Jersey (Channel Islands), Nevis, the Cook Islands and Belize, assets in an Alaska self-settled trust will also be insulated from claims of the grantor's creditors, even where the grantor retains a discretionary interest in the trust.

RULE AGAINST PERPETUITIES REPEALED

The first major change brought about by the Alaska Trust Act (effective from April 2, 1997) is the effective repeal of the common law rule against perpetuities. Specifically, the statute provides that the rule will not apply to trusts where:

'all or part of the income or principal of the trust may be distributed, in the discretion of the trustee, to a person who is living when the trust is created'. (Alaska Stat. § 34.7.050 (1999))

Under the new Alaska law, therefore, it is possible to create a trust that will never generate further estate taxes because it never vests absolutely, even in a remote generation. Also, because Alaska has no state income tax, it is possible that the income from the trust will completely avoid current and future state and local income taxes, assuming that no income is distributed currently to the beneficiaries.

The power of the new perpetual trusts now permissible under Alaska law is illustrated by the following example. In 1999, a grantor could transfer to an Alaska trust for the benefit of his or her children and more remote descendants an amount equal to his or her $650,000 (approximately £393,000) 'applicable exclusion amount.' This is the amount (increasing gradually to $1m in 2006) which a US citizen may transfer to US beneficiaries free of any transfer taxes. Assuming that the trust assets grew at 11 per cent per year compounded annually for 25 years, in the year 2024 the trust assets would exceed $8.83m (or approximately £5.34m). If the grantor had also allocated a portion of his or her $1m exemption from US generation-skipping transfer taxes to the initial contribution to the trust, the assets in that trust also should not incur any future generation-skipping transfer tax. The repeal of the rule against perpetuities effectively allows taxpayers to make their own decision about the level at which a trust will be taxed. While critics decry the repeal of the rule against perpetuities as a return to 'dead hand' rule, many of those same critics disparage the use which 'big government' makes of its tax revenue. Alaska allows trust creators to retain in trust for the benefit of their own families money that would have gone to the taxing authorities.

ASSET PROTECTION NOW POSSIBLE IN THE US

The second, and perhaps more far-reaching, aspect of the new Alaska trust law is that a grantor of a trust may retain a discretionary interest in the trust, without causing the trust assets to be subject to claims by the grantor's creditors, unless that transfer was fraudulent. Alaska Stat. §34.40.110 provides that so-called 'spendthrift clauses' in a trust, which prevent an existing or future creditor from satisfying the creditor's claim out of a beneficiary's interest in a trust, will be respected even to the extent of any interest the grantor retains in the trust, subject to certain restrictions (Alaska Stat. §34.40.110 (1999)). In particular, the spendthrift provisions will not be respected to the extent, if any, that any one of the four conditions are present:

- the transfer was intended to hinder, delay or defraud creditors or any other person;
- the trust provides that the grantor may revoke or terminate the trust without the consent of a person with a substantial beneficial interest in the trust which would be adversely affected by the revocation or termination (essentially, the trust must be irrevocable);
- the trust instrument requires that trust income and/or principal must be distributed to the grantor;

at the time of the transfer to the trust, the grantor is in default by 30 or more days in payments due under a child support judgment or order.

Even assuming a creditor could prove the transfer was intended to hinder, delay or defraud creditors, an existing creditor seeking to attack a transfer to the trust must bring an action within the later of four years after the transfer or one year after the transfer is or reasonably could have been discovered by the person. A subsequent creditor must bring an action within four years after the transfer to the trust and must prove it was intended to hinder, delay or defraud creditors.

Under US law, a transfer is complete for Federal estate and gift tax purposes if the grantor's creditors cannot reach the assets of the trust (*Rev Rul* 76–103, 1976–1 CB 293; *Rev Rul* 77–378, 1977–2 CB 347; *Paolozzi v Commissioner*, 22 TC 182 (1954); *Outwin v Commissioner*, 76 TC 153 (1981), *acq* 1981–2 CB 2). Because under Alaska law creditors cannot reach a grantor's interest in a self-settled trust, assuming that the transfer otherwise complies with the provisions of Alaska Stat. §34.40.110, a transfer to an Alaska trust should be complete for Federal estate and gift tax purposes.

Although the Internal Revenue Service has not ruled publicly on the impact of the Alaska statute, the gift tax consequences of the new law seem relatively certain. In PLR 9837007 (June 10, 1998), an Alaska domiciliary proposed to create a trust for the benefit of herself and her descendants. The trust would be funded with a combination of cash and marketable securities and possibly real property located in the State of Alaska. The grantor had no existing debts (other than a home mortgage loan). The trust instrument provided that the trustee, who was an unrelated third party, had sole and absolute discretion to pay out trust income and/or principal to such one or more of the grantor and her descendants. The taxpayer sought a ruling that her transfer to the trust would be complete for Federal gift and estate tax purposes.

The Service ruled that the gift was complete for gift tax purposes, holding that because Alaska law provides that the grantor's creditors may not reach her interest in the trust, the transfer would be a completed gift. The Service declined to rule, however, on whether the transfer was complete for estate tax purposes, and hence would be removed from the grantor's estate. At least one commentator has suggested that the Service is taking a 'wait and see' approach to the trust administration (David G Shaftel, *Newest Developments in Alaska Law Encourage Use of Alaska Trusts*, 26 Est Plan 51, 57, 1999). That is, whether the transfer is complete for estate tax purposes may depend on what types of distributions are made at what time to the grantor. If the Service finds evidence, through a pattern of distributions or otherwise, of a prior understanding that trust assets would be distributed to the grantor on a regular basis, the Service might well rule that the trust assets are fully includable in the grantor's estate. If, however, the grantor receives little or no trust assets during his or her lifetime, or only an occasional distribution, this may contribute to a determination that the assets are excludable from the grantor's estate.

USE BY US PERSONS

As US courts become increasingly hostile to asset protection trusts created by US grantors in non-US jurisdictions, the significance of the recent changes in Alaska law become readily apparent. Given that, historically, a common purpose for the creation of offshore trusts by US citizens has been the evasion of tax-reporting requirements, it is not unimaginable that a US bankruptcy or other court would presume fraud in the case of a debtor who chooses to settle his/her trust under the laws of Jersey (Channel Islands), for example, given that similar asset protection features are available under Alaska law.

A recent case decided by the US Court of Appeals for the Ninth Circuit may have struck the death-knell for the use of foreign asset-protection trusts by US citizens. In *FTC v Affordable Media LLC*, 179 F 3d 1228 (9th Cir 1999), Mr and Mrs Anderson created a trust under the laws of the Cook Islands. The explicit purpose of the trust, according to its creators (who were also co-trustees), was to protect assets from liabilities arising out the conduct of business. The Federal Trade Commission brought suit alleging that the Andersons engaged in telemarketing fraud which bilked unsuspecting investors out of more than $13m (or approximately £7.85m) by means of a classic Ponzi scheme. The Andersons' company, Financial Growth Consultants LLC, sold to unsuspecting investors media units which entitled the investor to a certain percentage of profits from the late-night television sales of products such as talking pet-identification tags and water-filled dumbbells. Since sales of the media units were sufficiently low, investors could not be paid.

A central issue in the case was the extent to which a US court could exercise jurisdiction over the foreign trust. When the US District Court directed the Andersons to repatriate any assets held by them, or for their benefit, outside the US, the Andersons claimed that they were legally unable to return the assets in the foreign trust. The Andersons claimed that the proceedings in the District Court constituted an 'event of default' under the terms of the trust instrument which therefore effectively removed them as trustees. When they directed AsiaCiti Trust Limited, the remaining trustee, to repatriate the assets, AsiaCiti refused to do so, and the Andersons claimed they had no further control over the trust.

The District Court first found the Andersons in contempt of court for failing to repatriate the trust assets and then ordered them taken into custody for failure to comply with the court order. Although the Andersons were released from custody pending appeal to the Ninth Circuit, the Ninth Circuit confirmed the contempt holding, unconvinced of the Andersons' inability to repatriate the trust assets, given that $1m (approximately £604,000) had been previously made available to them by the trustee for the payment of taxes. Furthermore, the court noted:

> '[given] *the nature of the Andersons' so-called 'asset protection' trust, which was designed to frustrate the power of US courts to enforce judgments',*

the Andersons, as the trust's creators, had by their own action made repatriation impossible. In such a case, according to the court, it is appropriate to exercise jurisdiction over the individual defendants by finding them in contempt of court and even to hold them in custody until they comply.

For those who are unwilling to risk jail time for their estate planning or asset protection efforts, Alaska trusts present an

attractive alternative to trusts settled under the laws of non-US jurisdictions. Also, for taxpayers who are unwilling to place a large amount of assets in a jurisdiction where the business, legal and political climate is substantially less stable than in the US, Alaska provides an alternative. Alaska is the better choice for those risk-adverse taxpayers who would rather have the security of knowing that their assets are held by a trustee in a jurisdiction governed ultimately by the US Constitution than by a trustee in a jurisdiction they had never heard of but that their attorney or financial advisor suggested.

The advantages of Alaska trusts notwithstanding, it is important to note that there are two significant ways in which an Alaska asset protection trust offers fewer protections than its offshore counterpart. First, as discussed elsewhere, Alaska courts will be required by the US Constitution to enforce judgments of other US jurisdictions against a creator of an Alaska trust or against the Trustee of a trust he or she has created (Richard W Hompesh II et al, 'Does the New Alaska Trust Act Provide an Alternative to the Foreign Trust?', *Journal of Asset Protection,* July/Aug 1997, at p. 1). Furthermore, the statutes of limitations on fraudulent transfers in many offshore jurisdictions are significantly shorter than Alaska's four-year rule (ibid, at p. 10). These factors will need to be taken into account by any taxpayer considering establishing an offshore trust. For most settlors of US trusts, however, these two factors, balanced against the real possibility of a contempt order or jail time, as in *FTC v Affordable Media LLC*, will not tip the scale in favour of an offshore trust.

USE BY NON-US PERSONS

Although it is likely that Alaska trusts will be employed most often by US citizens, the sweeping reforms to Alaska law present a planning opportunity for those who are neither US citizens nor US domiciliaries but who have US friends or family members whom they would like to benefit.

As a general matter, transfers by a foreign person to a US person are not subject to US transfer taxes (such as gift or estate tax) unless the transferred property is US real estate, tangible personal property, stock in a US corporation or certain US-based indebtedness (IRC § 2501(a)(2)). A transfer of non-US property outright to a US person would have the practical effect of eventually subjecting the property to tax at possibly two levels: first, to the extent that the property generated income, the beneficiary would owe income tax; second, to the extent that the asset was not expended during the beneficiary's lifetime, the value of the property would be likely to be included in the beneficiary's taxable estate. Thus, from a tax perspective, an outright gift by a non-US person to a US beneficiary is undesirable.

A transfer of non-US property by a non-US person to an Alaska trust for the benefit of US persons is a tax-advantaged strategy. Because the non-US property can be transferred without incurring any gift taxes under IRC §2511(a), non-US persons can give more 'cheaply' from a tax perspective than a similarly-situated US person could. Furthermore, all of the benefits of Alaska trusts remain available to non-US persons. Because the transfer to the trust is likely to be complete for US Federal gift and estate tax purposes, the non-US person could retain an interest in the trust without triggering any negative tax consequences to himself or herself. Also, because Alaska imposes no income tax on trusts, and trusts are permitted to last in perpetuity, the trust assets could be held without any imposition of estate tax or state or local income tax. A transfer to an Alaska trust therefore is superior to an outright transfer to a US person.

A transfer to an Alaska trust may be superior to a transfer to an offshore trust, as well. First, as a general matter, distributions from a foreign trust to a US beneficiary will be includable in the beneficiary's income to the extent of the trust's income. (IRC § 662). With an Alaska trust, in contrast, a beneficiary will not automatically report income as the trust earns income. Second, with foreign trusts, distributions of accumulated trust income are subject to high interest charges under IRC § 668. A distribution from a US trust incurs no interest charge. Finally, the US Federal Government has made the reporting requirements for foreign trusts more stringent, imposing strict requirements on information that must be reported as well as penalties in the event that the required information is not reported (IRC § 6048 and IRC § 6677). The rules with respect to US trusts are less onerous.

CONCLUSION

Although the asset-protection features of Alaska trusts may not be as strong in some respects as their offshore counterparts, the sweeping reform in Alaska law will enable those taxpayers who are interested in sophisticated estate planning to avail themselves of most of the positive features of offshore trusts without ever moving their assets outside the US. Because of the US courts' increasing hostility to foreign trusts, Alaska will see the continued growth of its trust industry. Furthermore, because Alaska trusts allow grantors to make transfers which are complete for gift tax purposes, and most likely for estate tax purposes as well, even though they retain an interest in the trust, Alaska trusts are ideal for someone who is interested in saving taxes, but who is not certain whether he or she might need the trust assets back someday.

From the perspective of sophisticated estate planners, Alaska is a wilderness no more.

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