

**ODDBALL TRUSTS
AND THE LAWYERS WHO LOVE THEM
OR
TRUSTS FOR POLITICIANS AND OTHER ANIMALS**

Wendy S. Goffe*

Editor's Synopsis: The world of trusts is broad and deep. Some types of trust are regularly employed to solve problems that estate planners recurrently encounter. This article, however, eschews description of these more common trust forms and instead focuses on the genus's more obscure species. In so doing, the author surveys the applications of and restrictions on a wide variety of trusts that can be used to meet specific estate planning needs. She also offers a cautionary description of the sham trust and clarifies the perils inherent in its use.

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* Wendy Goffe is a shareholder with the law firm of Graham & Dunn PC, Seattle, Washington. She is a Fellow of the American College of Trust and Estate Counsel (ACTEC). She has a comprehensive estate planning practice that involves all aspects of estate planning for high net worth individuals and families, advising both individuals and charitable organizations concerning planned giving, probate, and trust administration. She is a former adjunct instructor at Seattle University Law School.

This article is adapted from an earlier version, published by Wealth Strategies Journal, whose editor granted permission for this publication.

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I. INTRODUCTION

This article discusses trusts that are, for want of a better expression, off the beaten path of usual trusts encountered in estate planning. Some, such as constructive trusts, are not even trusts at all. This article addresses these trusts for three reasons: First, some of these little-known trusts fill an estate planning need in a way that no other arrangement could. Second, the article explains characteristics of sham trusts and how to avoid these kinds of “trusts.” Finally, because many of our clients (and, truth be told, some of our non-estate planning colleagues) assume that if property is in trust or an entity has *trust* in its name, it must relate to estate planning. This article discusses some of the more likely trusts that practitioners may encounter. A much broader world of trusts exists beyond the scope of this article, including revocable trusts, various types of irrevocable trusts such as Crummey trusts, dynasty trusts, asset protection trusts, marital trusts, special needs trusts, qualified subchapter S trusts, electing small business trusts, qualified

personal residence trusts, charitable lead and charitable remainder trusts, and qualified terminable interest property trusts, to name just a few.¹

Given the number of available trusts, this article is intended to be an overview and starting point for further research into the uses of any one particular trust. Part II of the article provides a brief outline and introduction. Part III discusses unusual trusts that still conform to the usual trust model. Part IV discusses commercial trusts, or corporations masquerading as trusts. Part V discusses trusts without a beneficiary, the so-called “purpose trusts.” Parts VI and VII discuss miscellaneous trusts, constructive trusts, and other trusts that defy categorization. Finally, Part VIII discusses sham trusts—creative criminal acts using a trust name.

II. EXPRESS TRUST DEFINED

An express trust is created when a grantor intentionally transfers legal ownership of property to a trustee for the benefit and enjoyment of a beneficiary, giving rise to a fiduciary relationship between the trustee and the beneficiary.² Trusts involve two distinct elements of asset ownership: legal title and beneficial title.³

The Internal Revenue Code (Code) does not expressly define a trust. However, U.S. Department of the Treasury regulations (Treasury Regulations) describe a trust as an entity, the purpose of which is to protect and conserve property for the benefit of beneficiaries “who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.”⁴ An entity that does not meet this definition of a trust is a business entity.⁵

Because trusts are taxed at compressed federal income tax rates and reach the top marginal rate sooner than an individual or corporation, they may incur greater income tax than a business entity. Conversely, the Code may subject a corporation’s income to two layers of tax. Thus, the optimal entity form for tax purposes may not always be obvious or solely tax driven. For the reasons discussed below, despite or because of the tax consequences, taxpayers choose to use the trust structure for any number of ar-

¹ See generally JESSE DUKEMINIER, ROBERT SITKOFF & JAMES LINDGREN, WILLS, TRUSTS & ESTATES (8th ed. 2009); JOHN R. PRICE & SAMUEL A. DONALDSON, PRICE ON CONTEMPORARY ESTATE PLANNING (2009).

² See RESTATEMENT (THIRD) OF TRUSTS § 2 (2003).

³ See *id.* cmt. d.

⁴ Treas. Reg. § 301.7701-4(a).

⁵ See *id.* § 301.7701-2.

rangements that, on their face, might be easier to administer in some other form. Sometimes they do this for reasons that are rational and readily apparent. Sometimes, however, trusts are used only because historically that is how it has been done.

For this discussion, trusts can be divided into the following categories:

1. Traditional, private express trusts that are funded by a grantor (theoretically, at least, with donative intent), held by a trustee, and having beneficiaries. These include alimony and maintenance trusts, health and education exclusion trusts, Delaware incomplete gift nongrantor trusts, oral trusts, and secret trusts;

2. Trusts with a commercial purpose that are essentially businesses masquerading as trusts. These include statutory business trusts, investment trusts, environmental remediation trusts, land trusts, liquidating trusts, and voting trusts;

3. Purpose trusts, which are most commonly represented by pet trusts, but also include gun trusts, funeral and qualified cemetery trusts, and trusts for artwork, automobiles, aircraft, and watercraft;

4. Constructive trusts, which are really remedies in equity by another name;

5. Certain trusts that defy categorization and are neither businesses nor trusts, but have features of both. These include blind trusts, Coogan trusts, rabbi trusts, Totten trusts, IOLTAs, and IRETAs;

6. Sham trusts, which are not legal trusts at all. Having a familiarity with sham trusts will help to educate clients as to the limits of trust use.

Each of these categories is discussed in detail below, though by no means exhaustively. As stated above, this discussion is intended as an introduction to raise awareness of the world of possibilities beyond the usual trust vehicles used in the estate planner's daily practice.

III. TRADITIONAL, PRIVATE EXPRESS TRUSTS

The first category of trusts essentially consists of traditional trusts deployed in unusual ways. A private express trust is one that the grantor creates gratuitously through the transfer of property to a trustee for the benefit of individual beneficiaries. The following trusts fit this traditional trust model.

Some of these trusts can be drafted as grantor or nongrantor trusts. A grantor trust is a trust in which the grantor or another person is deemed the owner of all or a portion of the trust for income tax purposes. Therefore, pursuant to Code section 671, those items of income, deductions, and credits against tax that are attributable to the owned portion of the trust are re-

ported by the grantor or other person. The remaining items of income, deductions, and credits are taxed to the trust or beneficiary, as applicable, in determining taxable income. Code sections 672 through 679 set forth the rules for determining when the grantor or another person is treated as the owner of any portion of a trust.⁶ A nongrantor trust is one that the Code

⁶ Sections 672 through 679 provide very generally as follows:

Section 672 contains definitions and rules for implementing the remaining sections.

Section 673 treats the grantor as the owner of any portion of a trust, in which the grantor retains from inception a reversionary interest in the trust corpus, the income therefrom, or trust income worth more than 5% of the trust value at the time of formation.

Section 674 treats the grantor, with a number of exceptions, as the owner of any portion of a trust, in which the beneficial enjoyment of the income or corpus is subject to a power of disposition exercisable by the grantor, a nonadverse party, or both, without the approval or consent of any adverse party. The most commonly used power under section 674 arises out of section 674(b)(5), which creates grantor trust status in both income and principal if any person—typically a third party to avoid inclusion of the trust in the grantor's estate under sections 2036(a)(2) and 2038(a)(1)—has the power to add to the beneficiary (or beneficiaries or to a class of beneficiaries) designated to receive income or corpus, except to provide for after-born or after-adopted children.

Section 675 provides that certain powers exercisable by the grantor or a nonadverse person for the benefit of the grantor or powers exercisable in a nonfiduciary capacity will cause grantor trust status. These powers include: the power to deal with trust assets for less than adequate and full consideration; the power to borrow trust assets without adequate interest and security; the ability to actually borrow trust assets without adequate security interest—whether or not provided for in the trust agreement—without repayment during the taxable year; and additional administrative powers exercised in a nonfiduciary capacity without a fiduciary's consent, including the power to vote stock or other securities of a corporation, in which the grantor holds voting control and the power to reacquire trust corpus by substituting other property of an equivalent value.

Pursuant to section 676, if a grantor, grantor's spouse, or any other nonadverse person retains the power to revest the title to the trust assets in the grantor, then the grantor will be treated as the owner of that portion of the trust.

Section 677 treats the grantor as the owner of the trust or trust portion as to which the grantor or any nonadverse person has the ability to use the trust income for the benefit of the grantor or the grantor's spouse in one or more enumerated ways in the statute without the consent or approval of an adverse person. Grantor trust status results when income may be distributed, either actually or constructively, to the grantor or the grantor's spouse; accumulated for future distribution to the grantor or the grantor's spouse; applied, either actually or constructively, to pay premiums on

treats as a taxable entity, independent from the grantor. The Code may treat a trust as a nongrantor trust with respect to all or only a portion of the trust assets.

As a general rule, a trust is not treated as a grantor trust merely because the trust's income could be applied or distributed for the support or maintenance of a beneficiary whom the grantor is obligated to support.⁷ However, to the extent such income is actually applied or distributed for the support or maintenance of such a beneficiary, the income will be taxed to the grantor.⁸ Accordingly, if a parent has a legal obligation to support a beneficiary (other than an ex-spouse) and the income from the trust is distributed or applied to the parent's obligations, the parent would be taxed on the income distributed or applied.

Finally, although in many instances one might question the gratuitous nature of the alimony and maintenance trust, it should be assumed to be present for the purposes of this discussion.

A. Health and Education Exclusion Trusts

The Health and Education Exclusion Trust (HEET) is a dynasty trust intended to pay medical and tuition expenses of skip-persons—persons two or more generations younger than the grantor⁹—for generation-skipping transfer (GST) tax purposes and to avoid a taxable termination.¹⁰ A taxable termination generally occurs when the last non-skip-person ceases to be a beneficiary, leaving only skip-persons as beneficiaries of the trust.¹¹ At that point, any trust distributions would be subject to the GST tax. Code section

policies of insurance on the life of the grantor or the grantor's spouse, other than certain charitable policies; or actually applied or distributed to discharge the grantor's or their spouse's legal obligation of support.

Section 678 treats a third person as the owner of all or a portion of the trust if they have a power exercisable alone to vest the corpus or income in themselves. Powers under section 678 include an *inter vivos* general power of appointment and a beneficiary demand or Crummey power.

Section 679 applies to certain foreign trusts having one or more U.S. beneficiaries.

⁷ See I.R.C. § 677(b).

⁸ See *id.*

⁹ See I.R.C. § 2613.

¹⁰ For a thorough analysis of HEETs, see Roy M. Adams, David A. Handler & Deborah V. Dunn, *A New Twist on Sec. 2503(e): Health and Education Exclusion Trust (HEET)*, TR. & EST., Jul. 2000, at 18; Michael N. Delgass & Deborah S. Gordon, *HEET Wave*, TR. & EST., Mar. 2005, at 20.

¹¹ See I.R.C. § 2612.

2503(e) excludes qualified transfers for tuition and medical expenses from gift taxes, and sections 2611(b)(1) and 2642(c)(3) exclude these types of gifts on behalf of a skip-person from the GST tax.

To qualify as a HEET, at least one beneficiary that is a non-skip-person must have a substantial present economic interest in the trust. Because a charity is a non-skip-person, a trust in which a charity possesses a substantial present economic interest avoids taxable transfers either upon creation or at the time of any subsequent distribution, unless the charity's inclusion was primarily to postpone or avoid application of the GST tax.¹²

No guidance exists as to the definition of *substantial present economic interest*. Many drafting attorneys consider a 10% unitrust amount paid annually to charity sufficient to demonstrate that the charity is a bona fide perpetual non-skip-person beneficiary. Others think that a 5% unitrust amount paid annually to charity is sufficient. Still others believe that 10% to 50% of the trust's income must be paid to charity annually.¹³

An *inter vivos* HEET can be structured as a grantor or a nongrantor trust. If structured as a grantor trust, the assets of a HEET would not be diminished by income tax during the grantor's lifetime. Of course, upon the grantor's death, the trust would cease to be a grantor trust and would instead be taxed as a complex trust.

A nongrantor trust could maximize the use of the charitable deduction. No gross income limitations on the charitable deduction apply to trusts as they do to individual taxpayers. Accordingly, a nongrantor trust may deduct up to 100% of its income for charitable contributions.

On the other hand, a nongrantor trust generates income tax liability for its noncharitable beneficiaries. Distributions paid on behalf of an individual beneficiary may carry out income on behalf of that beneficiary, who would then be required to pay income tax on the distribution under Code section 652 or section 662. To complicate matters, any distribution made directly to a skip-person to cover the tax liability would be subject to the GST tax. The trustee might avoid this result if it distributes distributable net income (DNI), as defined in section 643(a), to the charity and trust principal to individual beneficiaries. While this approach would deplete trust principal over time, it will reduce the income tax burden on the beneficiaries.

¹² See *id.* § 2652(c)(2). The charitable beneficiary or beneficiaries may be identified specifically or the trustee may be given discretion to choose the charities.

¹³ These ranges are based on provisions of the Code in which 5% is a threshold amount, including section 4942, describing minimum distributions for private foundations, and section 664, setting the minimum unitrust amount for charitable remainder trusts.

Some commentators have suggested that *any* distribution to the charity during the year will be treated as carrying out ordinary income (but not capital gains) and is thus made from DNI first, regardless of the order in which the distributions actually are made during the year. Others have suggested that it would be prudent to include in the document a provision directing that DNI be deemed to be distributed to charity first, up to the amount of the charitable distribution.

The trust instrument should define specifically those distributions that are qualified transfers, so that a trustee unfamiliar with the Code has a guide built into the trust document. With respect to education, these qualified transfers include tuition payments to an educational organization¹⁴ for the education or training of an individual if paid on behalf of the skip-person directly to the educational institution.¹⁵ Payments for other expenses—such as books, room, board, and fees—even though made directly, are not qualified transfers and would be subject to GST tax upon distribution.

Qualified transfers for health care are payments to any person who provides medical care (as defined in Code section 213(d)) as payment for that medical care.¹⁶ Accordingly, qualified transfers for medical care include medical and long-term care insurance premiums, which are within the definition of medical expenses for income tax purposes.¹⁷ Over-the-counter medications and cosmetic surgery would not be eligible transfers.¹⁸

Another issue is whether the separate share rule, which requires that separate and independent shares of different beneficiaries in the same estate or trust be treated as separate shares or trusts in determining the DNI allocable to the respective beneficiaries, applies to HEETs.¹⁹ The charitable and noncharitable interests in a HEET could be treated as separate shares. In that case, once the noncharitable portion of the HEET no longer has a non-skip-person as beneficiary, any distribution from that share would be treated as a taxable distribution for GST purposes.²⁰ To avoid separate-share characterization, the trustee should be given broad discretion to determine and

¹⁴ See *id.* § 170(b)(1)(A)(ii) (defining an educational organization for income tax purposes as one that maintains a regular faculty and has both a regularly enrolled body of students and an established curriculum).

¹⁵ See *id.* § 2503(e)(2)(A).

¹⁶ See *id.* § 2503(e)(2)(B).

¹⁷ See I.R.S. Pub. 502, at 9 (2010), available at <http://purl.access.gpo.gov/GPO/LPS8149>.

¹⁸ See *id.* at 16.

¹⁹ See I.R.C. § 663(c).

²⁰ See Treas. Reg. § 26.2654-1(a)(1)(i).

vary the annual charitable distribution rather than tying that distribution to the amount distributed to noncharitable beneficiaries.

HEETs often receive funding from the assets of a charitable remainder trust, charitable lead trust, or grantor-retained annuity trust. A life insurance policy may also fund a HEET so that during the life of the insured the HEET is treated as a conventional irrevocable life insurance trust. Because of the complexities involved with a HEET, only clients who have no remaining GST exemption, have charitable goals, and wish to create an education and healthcare safety net for future generations should consider employing this technique.

B. DING Trusts

A Delaware incomplete gift nongrantor (DING) trust is a nongrantor self-settled irrevocable trust established to avoid state income tax on undistributed ordinary income and capital gains.²¹ While the title suggests that it is strictly a Delaware trust, a DING trust can be settled under any state that allows for self-settled spendthrift trusts—often referred to as domestic asset protection trusts. Other states with laws similar to Delaware's Qualified Dispositions in Trust Act²² include Alaska, Nevada, New Hampshire, Rhode Island, South Dakota, Tennessee, Utah, and Wyoming.²³

This type of irrevocable trust must have several key features:

1. The trust must be self-settled and the grantor must retain the right to make distributions to herself.
2. It must be a nongrantor trust for income tax purposes so that it is a separate taxpayer. This is done by requiring the consent of an adverse party, as defined in Code section 672(a), for any trust distribution and prohibiting the application of any of the grantor trust powers enumerated in Code sections 671 through 678. Typically, the adverse party is a distribution commit-

²¹ See Thomas R. Pulsifer & Todd A. Flubacher, *Eliminate a Trust's State Income Tax*, TR. & EST. May 2006, at 30; Bruce D. Steiner, *The Accidentally Perfect Non-Grantor Trust*, TR. & EST. Sept. 2005, at 28; see also Priv. Ltr. Ruls. 2007-31-019 (May 1, 2007), 2007-29-025 (Apr. 10, 2007), 2007-15-005 (Jan. 3, 2007).

²² DEL. CODE ANN. tit. 12, §§ 3570–76 (2007 & Supp. 2010); see also Anne Marie Levin & Thomas R. Pulsifer, *Delaware Trusts*, EST. PL., Jun. 2009, at 14 (discussing Delaware trusts generally).

²³ See ALASKA STAT. § 34.40.110 (2008); NEV. REV. STAT. ANN. §§ 166.010–.170 (LexisNexis 2009 & Supp. 2009); N.H. REV. STAT. ANN. §§ 564-D:1–18 (LexisNexis Supp. 2010); R.I. GEN. LAWS §§ 19-9.2-1 to -7 (2003 & Supp. 2010); S.D. CODIFIED LAWS §§ 55-16-1 to -16 (Supp. 2011); TENN. CODE ANN. §§ 35-16-101 to -112 (2007 & Supp. 2010); UTAH CODE ANN. § 25-6-14 (LexisNexis 2007); WYO. STAT. ANN. §§ 4-10-510 to -523 (2011).

tee composed of two permissible beneficiaries of the trust other than the donor.

3. It must be an incomplete gift pursuant to Treasury Regulation section 25.2511-2(c) and therefore includable in the grantor's estate for estate tax purposes.

4. The grantor must retain a testamentary special power of appointment allowing the grantor to appoint trust property by will to persons other than the grantor, her estate, her creditors, or creditors of her estate. To the extent not so appointed, the trust agreement typically provides for the distribution of the property to the grantor's issue.

As a result, the gifts that the grantor makes to the trust are incomplete. Instead, the gifts become complete under Treasury Regulation section 25.2511-2(f) only when distributions are made to a beneficiary other than the grantor.

A typical DING trust scenario involves a self-settled irrevocable trust with a two-member distribution committee.²⁴ The committee could act only upon unanimous agreement—or the grantor could act in agreement with one member of the committee—to make distributions to the grantor, the grantor's spouse, or the grantor's descendants.²⁵ The committee would be composed of adverse parties.²⁶ At death, the grantor could exercise a limited power of appointment over the remaining trust assets, which would otherwise pass as provided in the agreement.²⁷

The purpose of the DING trust is not to avoid federal income, gift, or estate taxes; rather, it is intended to give the grantor creditor protection to the extent permitted under governing law and to minimize *state* income tax exposure on both accumulated and distributed income, depending upon applicable state income tax laws.

C. Rabbi Trusts

A rabbi trust is a type of trust commonly used in connection with various nonqualified deferred compensation arrangements.²⁸ The trust can be

²⁴ See Priv. Ltr. Rul. 2007-31-019 (Aug. 3, 2007).

²⁵ See *id.*

²⁶ See *id.*

²⁷ See *id.*

²⁸ See Rev. Proc. 92-64, 1992-2 C.B. 422, 422, modified by Notice 2000-56, 2000-2 C.B. 393. ERISA generally requires an employee benefit plan to hold its assets in trust. While many aspects of the law governing such trusts are based on traditional common law principles, a unique body of law has developed around them as well. This body of law is

revocable, irrevocable, or irrevocable only upon the occurrence of a defined event.²⁹ The first rabbi trust was set up for the benefit of a rabbi, resulting in the name.³⁰

Highly compensated executives frequently wish to defer the receipt of salary, bonuses, and other types of compensation to minimize income taxes. Compensation deferral may be particularly attractive to key employees in high tax brackets with adequate cash flows. Employers wishing to accommodate these employees frequently establish deferred compensation plans.

Deferred compensation plans can be funded or unfunded. In a funded deferred compensation plan, the employer sets aside funds now or makes current arrangements (for example, insurance) to secure payment of the deferred compensation. The employer must structure funded deferred compensation carefully to avoid taxing the employee currently on the deferred benefits.

Funding is desirable from the point of view of an executive deferring compensation because a funded plan can provide a certain level of assurance that assets will be available to pay the deferred compensation when payment becomes due at a future date, such as retirement. Moreover, an employer can structure a funded plan to ensure that it will not later renege on its promise to pay the deferred compensation, which might occur, for example, if the employer is taken over in a hostile acquisition.

In 1992, the Internal Revenue Service (Service) set forth a model rabbi trust agreement for use in deferred compensation arrangements.³¹ The model agreement is intended as a safe harbor—an agreement that, if adopted and maintained in accordance with its terms, will generally prevent the Service from treating the assets as income when they are transferred to the trust.³²

The essential features of the model agreement include the following:

1. The trust qualifies as a grantor trust with respect to the employer;³³
2. The trust can be revocable, irrevocable, or initially revocable and then irrevocable after the occurrence of certain events;³⁴
3. The trustee must be an independent third party;³⁵

within the general purview of ERISA attorneys and other employee benefit specialists and is beyond the scope of this discussion.

²⁹ See *id.* at 424.

³⁰ See Priv. Ltr. Rul. 81-13-107 (Dec. 31, 1980).

³¹ See Rev. Proc. 92-64, 1992-2 C.B. 422, 423, *modified by* Notice 2000-56, 2000-2 C.B. 393 containing a model trust agreement for use in rabbi trust arrangements.

³² See *id.*

³³ See *id.* at 424.

³⁴ See *id.*

4. The trust agreement must indicate how and when the employer will make contributions to the trust;³⁶
5. The employee must be prohibited from assigning his benefits prior to a distributable event under the plan;³⁷
6. No assets may revert to the employer until all benefits are paid;³⁸
7. While assets of the trust must be held separate and apart from other employer funds, the employee's interest in the trust will not be treated as property under Code section 83(a) (triggering income inclusion) so long as the trust assets remain subject to the claims of the employer's general creditors in the event the employer becomes insolvent;³⁹
8. Benefit payments to the employee must be suspended if the trustee receives notice of the employer's insolvency.⁴⁰

The requirement that the employee remain an unsecured creditor of the employer if the employer becomes insolvent detracts considerably from the ability of a rabbi trust to assure employees that funds will later be available to pay deferred compensation. But this treatment as an unsecured creditor is necessary to prevent the employee from being taxed currently on the value of assets transferred to the trust.

D. Oral Trusts

Trusts created as a product of professional legal advice are almost always reduced to a writing that evidences the identity of the parties, their intent, and the trust's operative terms. However, as a vestige of common law, which recognized oral trusts, the Uniform Trust Code (UTC) acknowledges that under certain circumstances a grantor may create a trust orally.⁴¹ Generally, the terms of an oral trust must be proven by clear and convincing evidence.⁴²

³⁵ *See id.* at 423.

³⁶ *See id.* at 424.

³⁷ *See id.* at 427.

³⁸ *See id.* at 425.

³⁹ *See id.* at 424.

⁴⁰ *See id.* at 425.

⁴¹ *See* UNIF. TRUST CODE § 407 (amended 2005), 7C U.L.A. 489 (2006) ("Except as required by a statute other than this [code], a trust need not be evidenced by a trust instrument, but the creation of an oral trust and its terms may be established only by clear and convincing evidence.").

⁴² *See id.* This is generally a higher standard of proof than is in effect in many states. *See id.* cmt. (citing RESTATEMENT (THIRD) OF TRUSTS § 20 reporter's notes (Tentative Draft No. 1, 1996)). The comment also provides that "[a]bsent some specific statutory provision,

The Statute of Frauds, enacted in England in 1677, generally required that trusts be in writing.⁴³ In some states, the statute of frauds still may bar a finding of an oral trust or an oral trust involving real property.⁴⁴

Some states permit the creation of an oral trust but require a subsequently signed, written memorandum with a narrative of the transfer.⁴⁵ In other states, even if the written instrument does not evidence an intent to create a trust, the circumstances may suffice to find an oral trust.⁴⁶ In still other states, if a grantor has entrusted the care of property to another party and either an express agreement exists or the conduct of the parties evidences intent, an enforceable oral trust may be found.⁴⁷

When a grantor conveys property subject to an oral trust and the transferee refuses to honor the oral arrangement, a constructive trust may result. A constructive trust is not a trust; it is an equitable remedy used to resolve issues between parties as to the ownership of certain property (which are discussed in Part VI below).⁴⁸

E. Secret Trusts and Semi-secret Trusts

When a decedent leaves property—whether by testamentary instrument or by intestate succession—outright to a person who has separately agreed to hold the property in trust pursuant to an express or implied agreement, the decedent creates a secret trust.

Restatement (Third) of Trusts describes the circumstances under which a secret trust arises as follows:

1. Where a testator devises or bequeaths property to a person in reliance on the devisee's or legatee's expressed or implied agreement to hold the property upon a particular trust, no express trust is created, but the devisee or legatee

such as a provision requiring that transfers of real property be in writing, a trust need not be evidenced by a writing. States with statutes of frauds or other provisions requiring that the creation of certain trusts must be evidenced by a writing may wish specifically to cite such provisions." *Id.*

⁴³ See An Act for Prevention of Frauds and Perjuryes, 1677, 29 Car. 2, c.3 (Eng.), superseded by Law of Prosperity Act, 1925, 15 & 16 Geo. 5, c.20, § 53 (Eng.).

⁴⁴ For an in-depth discussion of those states permitting oral trusts of land and the variations on the treatment of such oral trusts, see Frank S. Berall, *Oral Trusts and Wills: Are They Valid?*, EST. PLAN., Nov. 2006, at 17.

⁴⁵ See *id.* at 19; UNIF. TRUST CODE § 407.

⁴⁶ See Berall, *supra* note 44, at 19, n. 27–30 and accompanying text.

⁴⁷ See *id.*

⁴⁸ See *id.* at 20.

holds the property upon a constructive trust for the agreed purposes and persons.

2. Where a property owner dies intestate relying upon the expressed or implied agreement of an intestate successor to hold upon a particular trust the property acquired by intestate succession, no express trust is created, but the intestate successor holds the property upon a constructive trust for the agreed purpose and persons.⁴⁹

The first case to distinguish a secret trust and a semi-secret trust was *Olliffe v. Wells*.⁵⁰ A secret trust arises when a testamentary instrument itself does not reflect an intent to create a trust, but a devisee or legatee promises to do so. A semi-secret trust arises when a testamentary instrument reflects the intent to create a trust, but the agreed upon terms, including the intended beneficiaries, the purposes, or both, do not appear in the agreement.⁵¹

In some states, to avoid unjust enrichment, the state can compel the devisee or legatee of a secret trust to hold the property in constructive trust—or, with respect to a semi-secret trust, a resulting trust—for the intended beneficiaries.⁵²

The burden of proving the existence of a secret or semi-secret trust is different than proving one is an intended beneficiary. The burden of proving the *existence* of a secret or semi-secret trust is upon those claiming to be beneficiaries.⁵³ With respect to the secret trust, the claiming beneficiaries must prove the existence by clear and convincing evidence because the proof must substitute for a will.⁵⁴ With respect to the semi-secret trust, the claiming beneficiaries have no special burden of proof because they need not prove the terms of a will, only clarify them. For both semi-secret trusts and secret trusts, those claiming to be the intended beneficiaries need only prove the *essential terms* of the trust by a preponderance of the evidence.⁵⁵

In practice, state laws make it difficult to intentionally form a secret trust. In most states, the trustee has a nonwaivable duty to keep beneficiaries informed about the trust.⁵⁶ Some states, such as Delaware, authorize a trust

⁴⁹ RESTATEMENT (THIRD) OF TRUSTS § 18 (2003).

⁵⁰ 130 Mass. 221 (1881).

⁵¹ See RESTATEMENT (THIRD) OF TRUSTS § 18 cmt. a (2003).

⁵² See *id.*

⁵³ See *id.* cmt. h.

⁵⁴ See *id.*

⁵⁵ See *id.*

⁵⁶ See, e.g., CAL. PROB. CODE 16060, 16061, 16061.5, 16062 (West 2011); UNIF. TRUST CODE § 813 (amended 2005), 7C U.L.A. 611 (2006) (setting forth the trustee's duty to

provision allowing a trustee not to inform a beneficiary for a finite period of time.⁵⁷ Whether section 11.97.010 of the Revised Code of Washington, which provides the grantor with the right to relieve the trustee of certain duties, might permit a secret trust is unclear.⁵⁸ However, except with respect to blind trusts, which are discussed below in Section VII.A, most state laws provide that a beneficiary has some right to request information sufficient to enforce rights under the trust agreement.⁵⁹

Because of the inherent difficulties in proving the existence and terms of a secret or semi-secret trust, disappointed heirs often invoke these theories as a means of seeking equitable relief, along with intentional or tortious interference with an inheritance and imposition of a constructive trust.⁶⁰

F. Alimony and Maintenance Trusts

Close cousins of traditional trusts are alimony and maintenance trusts. An exception to the general grantor trust rules exists for certain trusts formed in connection with a divorce. These trusts are generally known as alimony trusts or maintenance trusts (depending upon applicable state law), or section 682 trusts (because Code section 682 governs them). Under section 682(a), if an alimony trust is structured to pay income to an ex-spouse pursuant to a dissolution decree, separation decree, or written separation agreement, the payee—not the payor—will be taxed on the income received (even though the trust income would otherwise be taxable to the payor under the grantor trust rules).⁶¹ Section 682 also applies to payments from a trust that the payor or ex-spouse created prior to the marital dissolution and not incident to it, but included in the settlement.⁶²

The governing instrument of an alimony trust typically provides that the trust's income shall be distributed to the former spouse or for the former spouse's benefit until the earlier of the following: (1) the former spouse's

inform and report); *see also* Dana G. Fitzsimons Jr., *Navigating the Trustee's Duty to Disclose*, 23 PROB. & PROP., Jan./Feb. 2009, at 40, 42 (discussing the disclosure requirements under the UTC and their varying application by state).

⁵⁷ See DEL. CODE ANN. tit. 12, § 3819(c) (2007).

⁵⁸ See WASH. REV. CODE ANN. § 11.97.010 (West 1998).

⁵⁹ See RESTATEMENT (THIRD) OF TRUSTS § 82; UNIF. TRUST CODE § 813; *see also* Fitzsimmons, Jr., *supra* note 56, at 42.

⁶⁰ Martin L. Fried, *The Disappointed Heir: Going Beyond the Probate Process to Remedy Wrongdoing or Rectify Mistake*, 39 REAL PROP. PROB. & TR. J. 357, 379 (2004).

⁶¹ See I.R.C. § 682(a); Treas. Reg. § 1.682(a)-1(a)(3). The beneficiary reports distributions as income, to the extent of the trust's distributable net income received.

⁶² See Treas. Reg. § 1.682(a)-1(a)(2).

having received a stated amount of money; (2) the death of the former spouse; or (3) a specific term. At the termination of the former spouse's interest, the trust often continues for the benefit of the payor spouse's children.

An alimony trust may be particularly useful if a business owner cannot or does not want to sell an interest in the family business to make payments to his former spouse or if the business lacks the liquidity to redeem the stock of the former spouse. The business owner could fund an alimony trust with equity in the family business, shifting the income generated by the equity interest to the former spouse for a defined term. The business owner could even serve as trustee, and the trust instrument could provide that the former spouse's interest reverts back to the business owner upon termination.

A Section 682 Trust presents a number of advantages:

1. The trust is not subject to Code section 71(b)(1)(D), which requires taxable support payments to terminate at the death of the transferee ex-spouse. Thus, the trust may continue for the benefit of the children at the death of the payee or ex-spouse (but will no longer be taxable as an alimony trust).

2. An alimony trust can protect the payee or ex-spouse from the payor's death or financial insolvency before all payments are made.

3. It gives the payor assurance that transferred property remaining at the death of the payee will pass to the residuary beneficiaries named in the agreement.

4. A neutral third-party trustee may professionally manage the trust and act as an intermediary between the former spouses.

5. It may avoid Code section 71(f)'s recapture rules applicable to front-loading direct alimony payments. As a result, alimony payments may be made from a trust in decreasing amounts without penalty.

6. It is not subject to the "Anti-Lester" Rule that requires the transferor or ex-spouse, not the transferee ex-spouse, to include in income any payments—except child support payments—that terminate upon the occurrence of a contingent event related to a child.⁶³ For example, if an ex-husband were to make payments to his ex-wife for her support until their child graduates from high school, section 71(c) would require the ex-husband, not the

⁶³ See I.R.C. § 71(c)(2). In *Comm'r v. Lester*, 366 U.S. 299 (1961), the Court held that for an order in which child support and spousal support are combined, the entire amount is deductible as spousal support. See *id.* at 300–01. Section 71(c) reversed the Court's holding in *Lester*, providing that—regardless of the label—any payments subject to a contingency associated with a child are nondeductible support.

ex-wife, to include these payments in his income because of the contingent event related to their child. If these payments were instead made from a trust, the remainder of which is to revert to ex-husband upon the happening of an event related to their child (for example, graduation), the ex-husband could avoid the application of section 71(c), and section 682(a) would require the ex-wife to include the payments in her gross income.⁶⁴ The special treatment of income distributions for alimony under section 682 is not available for trust distributions for child support payments; the payor or ex-spouse would pay tax on these distributions under the normal grantor trust rules.⁶⁵

The downside of an alimony trust is that it may be underfunded. Overfunding or funding the alimony with assets that appreciate more than expected is also possible and would result in more value than expected passing to the residuary beneficiaries. One should contemplate both when drafting the agreement.

IV. COMMERCIAL TRUSTS

The common law commercial trust, also referred to as a business trust, emerged in the seventeenth century.⁶⁶ The business trust is a “woefully under-analyzed and under-appreciated form of business organization.”⁶⁷ Generally, a common law business trust is an unincorporated business organization created by an instrument that defines how a trustee must hold and manage property for the benefit and profit of its beneficial owners. History has viewed the common law business trust as an evasion of corporate law.⁶⁸

The traditional trust involves a gratuitous transfer that implies that the grantor receives no compensation for that transfer and often retains no further interest in the trust corpus. A trustee’s common law fiduciary duties of care and impartiality limit the use of traditional trust assets in many circumstances, particularly with respect to adherence to the prudent investor rules.

⁶⁴ If a section 682 trust does not specifically allocate its distribution between alimony and child support, all of the trust income distributed will be included in the recipient’s taxable income. See I.R.C. § 682(a); Treas. Reg. § 1.682(a)-1(a)(3).

⁶⁵ See I.R.C. § 682(a).

⁶⁶ See NICHOLAS G. KARAMBELAS, *LIMITED LIABILITY COMPANIES: LAW, PRACTICE AND FORMS* § 11:2 (2d ed. 2004 & Supp. 2010).

⁶⁷ Paul B. Miller, *The Future for Business Trusts: A Comparative Analysis of Canadian and American Uniform Legislation*, 36 *QUEEN’S L.J.* 443, 444 (2011).

⁶⁸ See, e.g., Tamar Frankel, *The Delaware Business Trust Act Failure as the New Corporate Law*, 23 *CARDOZO L. REV.* 325, 326 n.4 (2001).

On the other hand, the business trust is typically funded in a bargained-for exchange with a goal of managing the assets for profit. The grantor typically retains an interest in the assets as a beneficiary, and the beneficiary and the trustee share the risk of loss and the possibility of profit. The business trust arrangement, which allows the trustee to make risky investments for entrepreneurial gain and share that risk with the beneficial owners, clearly contradicts the traditional understanding of the relationship among trustees, beneficiaries, grantors, and fiduciaries.

A. Common Law Business Trusts

The common-law business trust has a number of limitations, including a lack of clarity as to whether it consistently confers limited liability on its investors.⁶⁹ At least thirty states have enacted business trust statutes because of the many limitations of the common law business trust and the common-law limitations on fiduciaries.⁷⁰ In addition, on July 15, 2009, the National Uniform Conference of Commissioners of Uniform State Laws (NCCUSL) approved the Uniform Statutory Trust Entity Act, which is based on the Delaware Statutory Trust but contains a number of innovations.⁷¹

B. Statutory Business Trusts

Statutory business trusts are more relevant to issues of income tax and corporate and bankruptcy law, and will only be described here briefly. Massachusetts was the first state to enact a business trust statute.⁷² Each business trust statute, to a certain extent, attempts to define the rights of the parties involved and permit limited liability, creditor protection, and even statutory limitations that might result in the ability to take valuation discounts.⁷³ Statutory business trusts—unlike the common law variety—are separate from their trustees and beneficial owners; they can sue, be sued, and transact business in the name of the trust (but not in the name of the trustees). Some statutes refer to the state's more flexible corporate law if a gap in the statute exists; others refer to the state's stricter trust laws. This

⁶⁹ *See id.*

⁷⁰ *See* UNIF. STATUTORY TRUST ENTITY ACT prefatory note, 6B U.L.A. 66 (Supp. 2011).

⁷¹ *See id.*

⁷² *See* Robert H. Sitkoff, *Trust as "Uncorporation": A Research Agenda*, 2005 U. ILL. LAW. REV. 31, 36 (2005).

⁷³ *See, e.g.*, DEL. CODE ANN. tit. 12, §§ 3801–3862 (2007 & Supp. 2010); MASS GEN. LAWS ANN. ch. 182, §§ 1–14 (West 2010); WASH. REV. CODE ANN. § 23.90 (West 2011).

results in inconsistent state standards of care, fiduciary duties, and limitations on liability.⁷⁴

For example, under section 23.90.020 of the Revised Code of Washington, a business trust is treated as an unincorporated business association and is created by an instrument under which trustees hold and manage property for the benefit and profit of the holders (whether by commercial transaction or donative transfer) of transferable certificates that evidence beneficial interests in the trust estate.⁷⁵

Like a corporation, a Washington business trust must file a copy of the trust agreement and any amendments with the Secretary of State.⁷⁶ A business trust is also subject to Washington's corporate law, as it relates:

to the issuance of securities, filing of required statements or reports, service of process, general grants of power to act, right to sue and be sued, limitation of individual liability of shareholders, rights to acquire, mortgage, sell, lease, operate and otherwise to deal in real and personal property, and other applicable rights and duties existing under the common law and statutes of this state in a manner similar to those applicable to domestic and foreign corporations.⁷⁷

In other words, Washington's corporate law, rather than its trust law (the default under the Delaware model), supplements any gaps in the statute.

In some states, businesses often choose trusts over corporations for their flexibility of management and control. In many states, statutes that subject the business trust to substantially the same regulations as a corporation cause the trust to lose its flexibility. Nevertheless, business trusts have become the preferred entity form for asset securitization and certain financial transactions related to mortgages, credit cards, and other debt, and many mutual funds, pension funds, real estate management investment companies, regulated investment companies, and real estate investment trusts, any of which could also be structured as a corporation, LLC, or partnership.⁷⁸

⁷⁴ See Sitkoff, *supra* note 72, at 35–39.

⁷⁵ See WASH. REV. CODE ANN. § 23.90.020 (West 2011).

⁷⁶ See *id.* § 23.90.040(1).

⁷⁷ *Id.* § 23.90.040(4).

⁷⁸ See John H. Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 YALE L.J. 165, 168–72 (1997); see also Steven L. Schwarcz, *Commercial Trusts as Business Organizations: Unraveling the Mystery*, 58 BUS. LAW. 559, 560, 573 (2003) (discussing in detail the formats a business trust may take).

One author has written, “[T]he popularity of the trust for managing funds is understandable given similarities between the management of pooled assets of multiple investors and the management of trust property for multiple beneficiaries of an ordinary private donative trust.”⁷⁹

The Treasury Regulations provide that “[t]he fact that any organization is technically cast in the trust form, by conveying title to property to trustees for the benefit of persons designated as beneficiaries, will not change the real character of the organization if the organization is more properly classified as a business entity under § 301.7701-2.”⁸⁰ Accordingly, if a trust has associates and a profit-making objective, it will not be treated as a trust subject to subchapter J of the Code; instead it will be treated as a corporation, partnership, limited liability company, or sole proprietorship. If the entity is organized as a trust for state law purposes but does not qualify as one for federal income tax purposes, the “check-the-box” regulations allow the entity, unless it is a corporation, to elect treatment as either an association or a partnership for federal tax purposes.⁸¹

Bankruptcy courts determine whether to recognize an entity as a business trust by applying rules different from those under the Code.⁸² Bankruptcy courts typically consider the following factors when determining whether a trust is conducting business: (1) whether its purpose is to generate profits; (2) whether it has the attributes of a corporation; (3) and, sometimes, whether the beneficial interests in the trust are transferable.⁸³

C. Investment Trusts

An investment trust is a trust formed by multiple individuals to pool funds for common investments, much like a limited liability company aggregates wealth and facilitates joint investing by family members.⁸⁴ Investment trusts typically consist of a fixed number of outstanding shares that may be in one or more classes and that can be bought and sold in the market.⁸⁵ An investment trust facilitates direct investment in the trust assets and has interests that are “substantially equivalent to undivided interests” in the

⁷⁹ Miller, *supra* note 67, at 8.

⁸⁰ Treas. Reg. § 301.7701-4(b).

⁸¹ *See id.* § 301-7701-2(b)(2), -3(a).

⁸² *See* 6 U.S.C. § 101(9)(A)(v) (2006).

⁸³ *See, e.g., In re Kenneth Allen Knight Trust*, 303 F.3d 671 (6th Cir. 2002).

⁸⁴ *See* Howard M. Zaritsky & Howard D. Rosen, 854-3d Tax Mgmt. Portfolio (BNA), *U.S. Taxation of Foreign Estates, Trusts and Beneficiaries*, A-1, A-8 to -10 (2008), for a discussion of investment trusts.

⁸⁵ *See* Treas. Reg. § 301.7701-4(c)(1).

trust corpus.⁸⁶ The Treasury Regulations distinguish statutory business trusts from investment trusts for income tax purposes, even though they may be operationally indistinguishable.

A trust with a single class of ownership interests may be classified as an investment trust if, under the trust agreement, no one may vary the investment of the certificate holders. “An investment trust with multiple classes of ownership interests ordinarily will be classified as a business entity under Treasury Regulation § 301.7701-2.”⁸⁷ An investment trust with multiple classes of ownership may be classified as a trust, however, if “there is no power under the trust agreement to vary the investment of the certificate holders,” and “the trust is formed to facilitate direct investment in the assets of the trust and the existence of multiple classes of ownership interests is incidental to that purpose.”⁸⁸

If an investment trust is classified as a trust for tax purposes (as opposed to an association or partnership), typically the trust is treated as a grantor trust because the grantors are also the beneficiaries and have the power to distribute income or principal to themselves. Nevertheless, certain investment trusts are subject to specialized statutory tax regimes and do not pay taxes as grantor trusts. These include real estate investment trusts⁸⁹ and common investment trusts.⁹⁰

D. Environmental Remediation Trusts

An environmental remediation trust is a type of business trust. It must be organized as a trust pursuant to state law and formed to collect and disburse funds for environmental remediation. Its contributors must have actual or potential liability under federal, state, or local environmental laws for environmental remediation of the waste site. Finally, it can not be a qualified settlement fund described in Treasury Regulation section 1.468B-1(a).⁹¹ The remediation must be related to an existing waste site and undertaken not as a for-profit business, but rather as a result of liability or potential liability under federal, state, or local law.⁹²

⁸⁶ *Id.* § 301.7701-4(c)(2).

⁸⁷ *Id.* § 301.7701-4(c)(1).

⁸⁸ *Id.*

⁸⁹ *See* I.R.C. §§ 856-859.

⁹⁰ *See id.* § 584; *see also* Alan S. Acker, 852-3d Tax Mgmt. Portfolio (BNA), *Income Taxation of Trusts and Estates*, A-20 (2007) (discussing the taxation of investment trusts and the various exceptions to the rules).

⁹¹ *See* Treas. Reg. § 301.7701-4(e)(1).

⁹² *See id.*

Remediation costs include the expense of “assessing environmental conditions, remedying and removing environmental contamination, monitoring remedial activities and the release of substances, preventing future releases of substances, and collecting amounts from persons liable or potentially liable for the costs of these activities.”⁹³

For federal tax purposes, each trust grantor is “treated as the owner of the portion of the trust contributed by that grantor” under rules provided in Code section 677 and Treasury Regulation section 1.677(a)-1(d).⁹⁴ If the remedial purpose of an environmental remediation trust changes or “becomes so obscured by business or investment activities” that it is no longer primary, it will lose its classification as an environmental remediation trust and will instead be treated as a business entity.⁹⁵

E. Statutory Land Trusts

Land trusts consist of charitable land trusts⁹⁶ and statutory land trusts. Unlike statutory land trusts, charitable land trusts are a form of purpose trust—a trust established for a specific purpose rather than for the benefit of individual beneficiaries. Section V of this article discusses purpose trusts generally.

Statutory land trusts are private, noncharitable trusts used to hold title to real property while keeping the identity of the beneficiaries confidential. Illinois and at least four other states allow the creation of a trust to hold real property by statute.⁹⁷ This type of statute is often referred to as an Illinois

⁹³ *Id.* The Treasury Regulations apply to remediation trusts meeting the requirements of section 301.7701-4(e)(1) on or after May 1, 1996, and certain trusts described in the regulations formed prior to that date. *See* Treas. Reg. § 301.7701-4(e)(5).

⁹⁴ Treas. Reg. § 301.7701-4(e)(2) (setting forth the reporting rules and referencing Treasury Regulation section 1.671-4(a)).

⁹⁵ *Id.* § 301.7701-4(e)(1).

⁹⁶ A charitable land trust, which may also be referred to as a land bank, is a nonprofit organization established to protect and preserve valuable open space or environmentally sensitive land. A land trust or land bank can take title in fee simple, to a remainder interest, or to a conservation easement over property. *See generally* Erin B. Gisler, *Land Trusts in the Twenty-First Century: How Tax Abuse and Corporate Governance Threaten the Integrity of Charitable Land Preservation*, 49 SANTA CLARA L. REV. 1123 (2009).

⁹⁷ *See, e.g.*, FLA. STAT. ANN. § 689.071 (West 1994 & Supp. 2011) (entitled the Florida Land Trust Act); HAW. REV. STAT. ANN. §§ 558-1 to -8 (LexisNexis 2006) (entitled Land Trust Act); 505 ILL. COMP. STAT. 75/1-8 (West 2004); IND. CODE ANN. §§ 30-4-2-13 to -14 (LexisNexis 2000); VA. CODE ANN. § 55-17.1 (2007 & Supp. 2011); *see also In re Estate of Tutules*, 22 Cal. Rptr. 427 (1962) (recognizing a land trust in California).

Land Trust, which name stems from the fact that Illinois was the first state to enact a land trust statute.⁹⁸

The Statute of Uses was originally enacted during the reign of King Henry VIII to invalidate gifts of land in trust.⁹⁹ English courts later modified the Statute of Uses to provide that it did not apply to a trust if the trustee was actively involved in managing the property in trust.¹⁰⁰ Land trust statutes represent a departure from the Statute of Uses, which some states still strictly enforce.¹⁰¹

At a minimum, a trustee of a land trust has a duty to terminate the trust at the instruction of the beneficiaries, to convey title, and to handle any other activities that affect title during the trust term. *Restatement (Second) of Trusts* provides the majority view that these powers are sufficient to avoid violating the Statute of Uses.¹⁰²

Rather than acting in the name of and on behalf of the trust, the trustee of a land trust takes both equitable and legal title to the real property. However, the trustee's only duties are to execute deeds and mortgages and carry out acts at the instruction of the beneficiaries on all matters affecting title. Because title is in the name of the trustee, to third parties who are unaware of the trust's existence, the trustee is not, strictly speaking, acting as an agent of the beneficiaries, but rather as a principal. Unless the applicable statute indemnifies the trustee, the prudent trustee will obtain a release and indemnification to protect itself accordingly.¹⁰³

The interests of beneficiaries in the trust are considered personal property, not real property.¹⁰⁴ Hence, the beneficiaries exercise all other rights with respect to the property on their own behalf and not as agents of the trustee. The beneficiaries enforce the terms of the trust and hold the exclusive right to manage, possess, and control the real property, including the

⁹⁸ *Hart v. Seymour*, 35 N.E. 246 (Ill. 1893), is thought to be the first case to recognize a land trust in Illinois. See Julius J. Zschau, Ulysses Clayborn & Andrew M. O'Malley, *Using Land Trusts to Prevent Small Farmer Land Loss*, 44 REAL PROP. TR. & EST. L.J. 521 (2009) (providing a comprehensive history of the land trust, along with forms and a fifty-state survey of land trust legislation).

⁹⁹ See David A. Thomas, *Anglo-American Land Law: Diverging Developments from a Shared History Part I: The Shared History*, 34 REAL PROP. PROB. & TR. J. 143, 181–89 (1999).

¹⁰⁰ See *id.* at 188.

¹⁰¹ See *id.* at 189.

¹⁰² See RESTATEMENT (SECOND) OF TRUSTS § 69 (1959).

¹⁰³ See FLA. STAT. ANN. § 689.071(7) (West Supp. 2011) (indemnifying the trustee unless the trustee is personally at fault).

¹⁰⁴ See, e.g., 765 ILL. COMP. STAT. 405/1 (West 2009).

power to sell, lease, or trade the property.¹⁰⁵ The beneficiaries can also name further trustees and beneficiaries of the trust.¹⁰⁶ Among themselves, beneficiaries are like partners or joint venturers. They owe a fiduciary duty to act in their mutual best interests and may not bind the trustee without its consent.

The hallmark of the land trust is that it provides limited access to information about the grantor or the beneficiaries of the trust. Once title is vested in the trustee, state law restricts the ability to pierce the veil of the trust instrument. The beneficiaries' identities may be obtained, however, by court order and, in some cases, must be disclosed to government agencies.¹⁰⁷

Typically, a land trust is taxed as a grantor trust but can be taxed as a business entity. Taxation turns on whether the purpose of the trust is to carry on a business among associates or simply to divide gain.¹⁰⁸ Beneficiaries who receive an interest by gift are not considered associates and therefore would be subject to the grantor trust rules.

Pursuant to Code section 6903(b) and Treasury Regulation section 301.6903-1(b), a beneficiary who transfers an interest in a land trust must file a notice within thirty days of the transfer, so that the Service can match the beneficiary with the property.¹⁰⁹ The beneficiary uses Form 56 for this purpose.

F. Liquidating Trusts

Liquidating trusts relate primarily to bankruptcy and income tax matters. A liquidating trust commonly liquidates assets of a dissolving or insolvent corporation subject to a bankruptcy plan under Chapter 11 of the Bankruptcy Code. The trust beneficiaries are the creditors, bondholders, and shareholders of the liquidating corporation.

Outside of the bankruptcy arena, liquidating trusts are often used by owners of property to facilitate the property's sale. Furthermore, liquidating trusts are also used in the process of winding up a company as part of corporate liquidation or dissolution. Under this scenario, the company being sold uses the liquidating trust to wind up its affairs, pay or adequately pro-

¹⁰⁵ *See id.*

¹⁰⁶ *See id.*

¹⁰⁷ In Illinois, the trustee must disclose the identity of all trust beneficiaries under certain circumstances, including in connection with any application to the State of Illinois or its agencies for any purpose. *See id.* at 405/2.

¹⁰⁸ *See Acker, supra* note 90, at A-19.

¹⁰⁹ *See Rev. Rul. 63-16, 1963-1 C.B. 350.*

vide for the payment of all liabilities, and then distribute the remaining proceeds of the sale to or for the benefit of its shareholders.

Some states, including Delaware, consider the former directors of a dissolved corporation to be fiduciaries to the creditors and stockholders, whether or not a liquidating trust has actually been created.¹¹⁰

The Treasury Regulations recognize a liquidating trust “if it is organized for the primary purpose of liquidating and distributing the assets transferred to it, and if its activities are all reasonably necessary to, and consistent with, the accomplishment of that purpose.”¹¹¹ If the liquidation is unreasonably prolonged or if business activities so obscure the liquidation function that the liquidation purpose is lost or abandoned, the status of the organization will no longer be that of a liquidating trust (with exceptions when continued business activities are necessary to preserve asset values).¹¹²

A liquidating trust may be taxed for federal income tax purposes in a number of different ways. It may be taxed as a grantor trust with the creditors as the grantors; as a grantor trust with the debtor as the grantor; as a trust subject to subchapter J of the Code with the creditors as the beneficiaries; as a partnership with the creditors as partners; as a corporation with the creditors as shareholders; or as an entity subject to the taxation rules of Code section 468B.¹¹³

Several Revenue Procedures set forth conditions for advance rulings on whether a trust qualifies as a liquidating trust. Revenue Procedure 82-58 discusses advance rulings for liquidating trusts in general.¹¹⁴ If the activities of the liquidating trust are limited to those activities necessary to accomplish its original purpose, it will be taxed as a trust and not a business organization.¹¹⁵

Revenue Procedure 94-45 sets forth a safe harbor for creditor-grantor trust treatment and deals specifically with advance rulings for liquidating

¹¹⁰ See *Gans v. MDR Liquidating Corp.*, No. 9630, 1993 WL 193526, at *9 (Del. Ch. Jan. 10, 1990); DEL. CODE ANN. tit. 8, § 227 (2001 & Supp. 2010).

¹¹¹ Treas. Reg. § 301.7701-4(d).

¹¹² See *id.*; see also *U.S. v. Davidson*, 115 F.2d 799, 801 (6th Cir. 1940).

¹¹³ See I.R.C. § 468B (addressing the federal income taxation of Qualified Settlement Funds, Designated Settlement Funds, and Disputed Ownership Funds, which are beyond the scope of this discussion).

¹¹⁴ See Rev. Proc. 82-58, 1982-2 C.B. 847, modified by Rev. Proc. 91-15, 1991-1 C.B. 484 (checklist questionnaire); Rev. Proc. 94-45, 1994-2 C.B. 684.

¹¹⁵ See *In re Tru Block Concrete Products, Inc.*, 27 B.R. 486, 489 (Bankr. S.D. Cal. 1983).

trusts created pursuant to a bankruptcy plan under Chapter 11.¹¹⁶ One requirement for creditor-grantor trust treatment is that the plan, disclosure statement, and trust agreement must require the beneficiaries to be treated as grantors and deemed owners of the trust estate.¹¹⁷ Furthermore, trust returns must be filed pursuant to Treasury Regulation section 1.671-4(a), which specifies the return requirements of a grantor trust.¹¹⁸

The formation and funding of a trust created pursuant to the safe harbor rules will be treated for all federal income tax purposes as if a transfer had been made from the bankruptcy estate to the beneficiaries, followed by a deemed transfer by the beneficiaries to the liquidating trust, and resulting in an immediately taxable event to the debtor and the beneficiary-creditors.¹¹⁹

Additional rules apply to trusts, subject to subchapter J of the Code, with respect to persons who acquired interests in the trust by purchase rather than by gratuitous transfer.¹²⁰

G. Voting Trusts

1. Background

A voting trust is an agreement among one or more shareholders or LLC members to legally transfer shares (or membership interests) and voting rights to a trustee, usually for a specific period of time or for a period contingent on a certain event. The first voting trust was used in 1888 as part of a reorganization plan, under which J. Pierpont Morgan, John Crosby Brown, and George Bliss were trustees.¹²¹ By the early 1900s, voting trusts had become a standard corporate practice.¹²²

A voting trust is distinguishable from a proxy, which is voidable in some cases and in all cases deals only with voting, because it may serve broader purposes. A blind trust is also by nature a voting trust but serves a broader purpose as well.¹²³

¹¹⁶ See Rev. Proc. 94-45, 1994-2 C.B. 684; see also Zaritsky & Rosen, *supra* note 84, at A-11 (analyzing Revenue Procedure 94-45 and the requirements of a liquidating trust created under Chapter 11 of the Bankruptcy Code).

¹¹⁷ See Rev. Proc. 94-45, 1994-2 C.B. 684.

¹¹⁸ See *id.*

¹¹⁹ See *id.*

¹²⁰ See Acker, *supra* note 90, at A-21 to -22.

¹²¹ See HARRY A. CUSHING, VOTING TRUSTS: A CHAPTER IN RECENT CORPORATE HISTORY 12 (1915).

¹²² See ALAN D. MORRISON & WILLIAM J. WILHELM, JR., INVESTMENT BANKING: INSTITUTIONS, POLITICS AND LAW 179 (2007).

¹²³ See *infra* Part VII.A.

New York was the first state to legislatively approve the voting trust.¹²⁴ Most states by now have adopted some form of voting trust statute.

Washington's voting trust statute states that one or more shareholders may create a voting trust to confer upon a trustee the right to vote or otherwise act on behalf of the shareholders.¹²⁵ Shareholders create a voting trust when they sign an agreement setting forth the provisions of the trust—which may include anything consistent with its purpose—and transfer legal ownership of their shares to the trustee.¹²⁶ Upon the signing of the voting trust agreement, the trustee must prepare and deliver to the corporation's principal office a list containing the name, address, and number and class of shares that each owner of a beneficial interest transferred to the trust.¹²⁷

A Washington voting trust becomes effective upon the date of registration of the first shares in the trustee's name and, like most other voting trust statutes, is valid for ten years following its effective date. However, the trustees can extend the trust for additional terms of not more than ten years if each shareholder party to the extension signs an extension agreement and obtains the voting trustee's written consent.¹²⁸ The voting trustee must deliver copies of the extension agreement and a list of beneficial owners to the corporation's principal office.¹²⁹

The Delaware voting trusts statute allows for tremendous flexibility (namely because it is not subject to a time limitation) and provides in part:

One stockholder or 2 or more stockholders may by agreement in writing deposit capital stock of an original issue with or transfer capital stock to any person or persons, or entity or entities authorized to act as trustee, for the purpose of vesting in such person or persons, entity or entities, who may be designated voting trustee, or voting trustees, the right to vote thereon for any period of time determined by such agreement, upon the terms and conditions stated in such agreement. The agreement may contain any other lawful provisions not inconsistent with such purpose. After the filing of a copy of the agreement in

¹²⁴ See Gary D. Berger, *The Voting Trust: California Erects a Barrier to a Rational Law of Corporate Control*, 18 STAN. L. REV. 1210, 1210 n.1 (1966).

¹²⁵ See WASH. CODE ANN. § 23B.07.300(1) (West 1994).

¹²⁶ See *id.*

¹²⁷ See *id.*

¹²⁸ See *id.* § 23B.07.300(3).

¹²⁹ See *id.* § 23B.07.300(3).

the registered office of the corporation in this State, which copy shall be open to the inspection of any stockholder of the corporation or any beneficiary of the trust under the agreement daily during business hours, certificates of stock or uncertificated stock shall be issued to the voting trustee or trustees to represent any stock of an original issue so deposited with such voting trustee or trustees, and any certificates of stock or uncertificated stock so transferred to the voting trustee or trustees shall be surrendered and cancelled and new certificates or uncertificated stock shall be issued therefore to the voting trustee or trustees. In the certificate so issued, if any, it shall be stated that it is issued pursuant to such agreement, and that fact shall also be stated in the stock ledger of the corporation. The voting trustee or trustees may vote the stock so issued or transferred during the period specified in the agreement. Stock standing in the name of the voting trustee or trustees may be voted either in person or by proxy, and in voting the stock, the voting trustee or trustees shall incur no responsibility as stockholder, trustee or otherwise, except for their own individual malfeasance. In any case where 2 or more persons or entities are designated as voting trustees, and the right and method of voting any stock standing in their names at any meeting of the corporation are not fixed by the agreement appointing the trustees, the right to vote the stock and the manner of voting it at the meeting shall be determined by a majority of the trustees, or if they be equally divided as to the right and manner of voting the stock in any particular case, the vote of the stock in such case shall be divided equally among the trustees.¹³⁰

2. *Purposes of Voting Trusts*

The objective of a voting trust may be to secure continuity of voting for officers and corporate programs, regardless of change in ownership of the beneficial interests in the stock; to facilitate a corporate reorganization; to secure the retention of control by the grantors; restrain minority stockholders; or to aid in creation of a monopoly.¹³¹

¹³⁰ DEL. CODE ANN. tit. 8, § 218(a) (2001).

¹³¹ See Cushing, *supra* note 121, at 15–16; see also Berger, *supra* note 124, at 1212–15.

Voting trusts also are used to resolve conflicts of interest. If the voting trustee votes the shares, rather than the original shareholder, in some circumstances this may mitigate or absolve the original shareholder from a potential conflict of interest.

In the present economy, lenders and other professionals commonly see voting trusts as a valuable tool in workouts and other Chapter 11 cases. Transferring voting rights of a company into the hands of a mutually accepted trustee may overcome problems caused by a lender's distrust of a company's owners and management.

3. *Voting Trusts in the Estate Planning and Marital Dissolution Context*

A voting trust can also be a valuable tool in a marital dissolution. For example, when a divorcing couple faces dividing an LLC or corporation they own, a voting trust would permit the active ex-spouse to continue to control the business, while the inactive ex-spouse would retain an equity interest.

The following are drafting tips for voting trusts in the estate planning and matrimonial law contexts:

1. The term of the voting trust should not exceed the shorter of any state law term limitation or the period for which payments—such as dividends—will be paid to the inactive spouse.

2. If the corporation is to distribute all income directly to the shareholder and the trustee is not to retain any portion of it, this should be stated in the agreement.

3. The responsibilities, duties, powers, and rights of the trustee should take into consideration the terms of the separation agreement and the restrictions on the inactive spouse.

4. If the active spouse serves as trustee and expects to be compensated, this should be spelled out exactly. Without this additional protection, little money could be left in the corporation for distribution as dividends.

5. To protect the inactive spouse's interests to the greatest possible degree, the inactive spouse should negotiate reasonable restrictions on how much the active spouse and other shareholders can withdraw as salary or benefits. Ideally, the company's shareholder agreement would clarify the rights of the inactive spouse in the stock held in a voting trust. For example, using language such as the following:

1.1 *Exclusive Right to Vote Shares.* During the term of the Voting Trust, including all extensions thereto, the Voting Trustees shall have the exclusive right to act with respect

to the shares held by them pursuant to this Agreement, including the *exclusive* right to vote such shares or to give written consent in lieu of voting thereon; provided, however, that the Voting Trustees' right to act in respect of the Shares, except as otherwise subject to any limitations contained in the Articles of Incorporation of the Corporation and to this Agreement.

V. PURPOSE TRUSTS

A purpose trust exists for a specific purpose rather than for the benefit of individual beneficiaries. Examples include trusts for a noncharitable purpose—most frequently for pets, artwork, or aircraft—and trusts for charitable purposes—notably, private foundations organized as trusts and charitable land banks.

A noncharitable purpose trust breaches a number of basic tenets of trust law. First, it violates the rule against perpetuities because it lacks a measuring life. Next, it has no ascertainable beneficiary whose identity can be established (although individuals may benefit through scholarships or grants).¹³² Finally, it lacks someone with standing to enforce it.¹³³ In spite of the fact that they have no ascertainable beneficiaries, the law permits charitable trusts because the attorney general of the applicable jurisdiction has the authority to enforce their terms.¹³⁴

The UTC and the Uniform Probate Code (UPC) specifically permit purpose trusts. UTC section 409 permits the creation of “a trust . . . for a noncharitable purpose without a definite or definitely ascertainable beneficiary or for a noncharitable but otherwise valid purpose to be selected by the trustee.”¹³⁵

Before purpose trusts were legally recognized, courts considered them honorary trusts, which were unenforceable if the named trustee failed to

¹³² See Jonathan Klick & Robert H. Sitkoff, *Agency Costs, Charitable Trusts, and Corporate Control: Evidence from Hershey's Kiss-Off*, 108 COLUM. L. REV. 749, 780 (2008).

¹³³ See Alexander A. Bove, Jr., *The Purpose of Purpose Trusts*, PROB. & PROP., May/June 2004, at 34, 34.

¹³⁴ See RESTATEMENT (SECOND) OF TRUSTS § 348 (1959) (defining a charitable trust as “a fiduciary relationship with respect to property arising as a result of a manifestation of an intention to create it, and subjecting the person by whom the property is held to equitable duties to deal with the property for a charitable purpose.”). See generally Joshua C. Tate, *Should Charitable Trust Enforcement Rights Be Assignable?*, 85 CHI.-KENT L. REV. 1045 (2009) (providing a history of the charitable purpose trust and the inherent challenges of enforcement of its purpose).

¹³⁵ UNIF. TRUST CODE § 409 (amended 2005), 7C U.L.A. 494 (2006).

carry out its specified purpose. However, the residuary beneficiaries could sue to terminate the trust.¹³⁶

Several countries have enacted legislation specifically to promote the use of noncharitable purpose trusts and serve as noncharitable purpose trust havens.¹³⁷ In 2008, Delaware enacted legislation to treat noncharitable and charitable purpose trusts as equivalent entities, except with respect to their federal tax consequences.¹³⁸

A. Taxation of Purpose Trusts

Because a purpose trust lacks an individual beneficiary, the federal tax consequences are complex and not clearly defined.¹³⁹ Typically, the Code would allow a deduction to the trust for distributions to an individual beneficiary carrying out income and require the beneficiary recipient to pay income tax on that distribution.¹⁴⁰ Different rules apply, however, when the beneficiary is not a person, as defined by Code section 7701(a), and thus not a taxpayer, but instead is a family cabin or a pet.

A purpose trust may be taxed as a grantor trust or a nongrantor trust, depending upon its drafting. If the purpose trust is a grantor trust, the taxation is relatively straightforward. All incidents of taxation pass through to the grantor. However, if the gift to the grantor trust was incomplete at funding, then, as funds are distributed, the grantor will be deemed to have made taxable gifts that are ineligible for annual exclusion treatment.¹⁴¹ When the gift to the trust was incomplete and a distribution is made to an entity, there is a look-through to the shareholders or owners who are considered the recipients of the gifts in proportion to their interests.¹⁴²

On the other hand, a nongrantor trust typically creates a tax liability for its beneficiaries to the extent of distributions received. "If the trust is a nongrantor [sic] trust and the funding of the trust was a completed gift, no addi-

¹³⁶ See RESTATEMENT (THIRD) OF TRUSTS § 47 (2003); see also Adam J. Hirsch, *Delaware Unifies the Law of Charitable and Noncharitable Purpose Trusts*, 36 EST. PLAN., Nov. 2009, at 13, 15.

¹³⁷ See Bove, Jr., *supra* note 133, at 34; Alexander A. Bove, Jr., *Rise of the Purpose Trust*, TR. & EST., Aug. 2005, at 18, 22.

¹³⁸ See Hirsch, *supra* note 136, at 14.

¹³⁹ See Gerry W. Beyer & Jonathan P. Wilkerson, *Max's Taxes: A Tax-Based Analysis of Pet Trusts*, 43 U. RICH. L. REV. 1219, 1229 (2009) (discussing the federal tax consequences of purpose trusts and pet trusts in particular).

¹⁴⁰ See I.R.C. §§ 651, 661.

¹⁴¹ See Treas. Reg. § 25.2511-1(c)(1); see also I.R.C. § 2501.

¹⁴² See Treas. Reg. § 25.2511-1(h)(1).

tional gifts would result when trust distributions are made in furtherance of [its] purpose."¹⁴³ However, if an entity receives a distribution, the entity would pay income tax, and the trust would be able to take a distribution deduction.¹⁴⁴

If the recipient is not an individual or an entity, income tax may be payable by "U.S. persons connected with or benefiting from the object or purpose of the trust."¹⁴⁵ In other words, although a distribution to a caretaker for the family cabin or the family pet would be treated as taxable income to the caretaker and entitle the trust to a distribution deduction, no authority clearly validates this position.¹⁴⁶ Another approach would be to have the trustee pay the tax without taking a deduction for distributions.

Distributions may also be subject to a GST tax.¹⁴⁷ If the purpose trust has no individual beneficiaries, a distribution should have no GST tax consequences because it has no skip-person.¹⁴⁸ On the other hand, if the trust's purpose permits distributions to or for the benefit of a noncharitable entity, distributions may be treated as if passed through to individuals. For example, if the purpose is to maintain a family corporation, distributions from the trust would be deemed to be for the benefit of the corporation's shareholders.¹⁴⁹ Accordingly, if a distribution is attributable to a shareholder who is a skip-person, it could be construed as a taxable distribution for GST tax purposes.¹⁵⁰

The following is a discussion of specific purpose trusts, some of which are highly regulated.

B. Funeral and Cemetery Trusts

Funeral and pre-need cemetery trusts are considered purpose trusts.¹⁵¹ At least forty-four states make them enforceable and not merely honorary trusts.¹⁵² A funeral trust is an arrangement between the grantor and funeral

¹⁴³ Bove, Jr., *supra* note 137, at 24.

¹⁴⁴ *See id.* at 24-25.

¹⁴⁵ *Id.*

¹⁴⁶ *See id.*

¹⁴⁷ *See* Bove, Jr., *supra* note 133, at 37.

¹⁴⁸ *See* I.R.C. § 2613(a).

¹⁴⁹ *See id.* § 2651(f)(2).

¹⁵⁰ *See id.* § 2612(b); *see also* Treas. Reg. § 25.2511-1(h)(1).

¹⁵¹ *See* 1 GERALD S. SUSSMAN, ESTATE PLANNING: FORMS, PRACTICE AND TAX ANALYSIS § 3.06, at 49 (2003).

¹⁵² *See* Hirsch, *supra* note 136, at 15.

home or cemetery to allow for the prepayment of funeral expenses prior to death. In addition to the funeral trust, two types of cemetery trusts exist, an endowment care cemetery trust and a service and merchandise trust. The endowment care cemetery trust is essentially a pooled income fund for ongoing maintenance of cemetery grounds, which is held in the name of the cemetery; earnings, but not principal, may be used for its stated purpose. The service and merchandise trust is like a funeral trust but pays for merchandise—such as a gravesite marker or mausoleum—and the burial service. The service and merchandise trust is equivalent, for tax purposes, to the funeral trust and will not be discussed here.

The Taxpayer Relief Act of 1997 enacted Code section 685 to simplify the taxation and reporting of earnings of funeral trusts.¹⁵³ Prior to 1997, pre-need funeral trusts were taxed as grantor trusts,¹⁵⁴ and the grantor was responsible for reporting income, unless the trustee elected against grantor trust treatment, in which case the trustee paid the tax.

Section 685 allows the trustee to elect qualified funeral trust status,¹⁵⁵ which permits the trustee to file one aggregate return reporting all of the income on the funds administered by the trustee on Form 1041 QFT.¹⁵⁶ Section 685 defines a qualified funeral trust as one that meets the following requirements:

1. The trust arises as a result of a contract with a person engaged in the trade or business of providing funeral or burial services or property necessary to provide such services.
2. The sole purpose of the trust is to hold, invest, and reinvest funds in the trust and to use such funds solely to make payments for such services or property for the benefit of the beneficiaries of the trust.
3. The only beneficiaries of the trust are individuals with respect to whom such services or property are to be provided at death under contracts described above.
4. The only contributions to the trust are contributions by or for the benefit of such beneficiaries.
5. The trustee elects the application of this subsection.

¹⁵³ See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1309, 111 Stat. 788.

¹⁵⁴ See Rev. Rul. 87-127, 1987-2 C.B. 156.

¹⁵⁵ See I.R.C. § 685(b)(5).

¹⁵⁶ See *id.* § 685(a)(2).

6. The trust would (but for the election described above) be treated as owned under subpart E by the purchases of the contracts described in paragraph (1).¹⁵⁷

The Service provides guidance on how to make the election, reporting rules, eligibility requirements, and how to treat payments the seller receives.¹⁵⁸ Until recently there was a \$7,000 contribution limit for qualified funeral trusts. In 2008, the Hubbard Act repealed that dollar limitation.¹⁵⁹

C. Gun Trusts

When an estate has firearms, the executor must be careful to avoid violating federal, state, and local firearms laws. Federal law prohibits possession of and access to certain weapons, regulates the transfer of permissible weapons, and bars certain persons from owning or having access to firearms. Failure to comply with these laws may result in criminal liability, including stiff punishments and fines and forfeiture of any weapons involved.¹⁶⁰ Careful estate planning can assist in compliance with some of these laws.

First, an understanding of the basic regulatory scheme under federal and state law is helpful. Federal firearms laws categorize weapons as either Title I firearms or Title II firearms.

Title I of the Gun Control Act of 1968, includes, but is not limited to, rifles, shotguns, and handguns.¹⁶¹ State law generally regulates the transfer of Title I firearms.

Title II of the Gun Control Act of 1968 re-enacted the National Firearms Act of 1934 (NFA).¹⁶² Title II weapons are also referred to as NFA weapons, and include machine guns, silencers, short or short-barreled (that is, sawed-off) shotguns, short or short-barreled rifles, destructive devices (such as grenades or bombs), and “any other weapon.”¹⁶³ The NFA Branch of the Bureau of Alcohol, Tobacco, Firearms, and Explosives (BATFE)

¹⁵⁷ *Id.* § 685(b).

¹⁵⁸ *See* Notice 98-6, 1998-3 I.R.B. 52.

¹⁵⁹ *See* Hubbard Act, Pub. L. No. 110-317, sec. 9, 122 Stat. 3526 (2008).

¹⁶⁰ *See* I.R.C. § 5872; 27 C.F.R. § 479.182 (2011).

¹⁶¹ *See* Gun Control Act of 1968, Pub. L. No. 90-618, 82 Stat. 1213 (codified at 18 U.S.C. §§ 921–930 (2006)).

¹⁶² *See id.* (re-enacting the National Firearms Act of 1934 (NFA), ch. 757, 48 Stat. 1236) (codified at I.R.C. §§ 5801–5872).

¹⁶³ *See* I.R.C. § 5845(a)–(e); 27 C.F.R. § 479.11. The definition of “any other weapon” includes smooth-bore rifles, muzzle-loading cannons, and other somewhat exotic firearms.

administers the National Firearms Registration and Transfer Record (NFA Registry).

Under Title II, certain weapons are subject to strict registration, transfer, and tax requirements.¹⁶⁴ It is illegal for any person to possess an NFA weapon that is not registered to that person in the NFA Registry.¹⁶⁵ Transferring an NFA weapon without complying with several NFA transfer rules¹⁶⁶ or possessing such a weapon is also illegal.¹⁶⁷ For example, when an individual transfers or purchases an NFA weapon, the Chief Law Enforcement Officer (CLEO) of the city or county where the individual resides must sign a document called a Form 4, Application for Transfer and Registration of Firearm.¹⁶⁸ Any transfer is also subject to a transfer tax, and the transferor must submit and attach to the form a photo of the transferee, as well as the transferee's fingerprints in duplicate.¹⁶⁹

Title II has a broad definition of *transfer*. Under the law, transfer “include[s] selling, assigning, pledging, leasing, loaning, giving away, or otherwise disposing of” an NFA weapon.¹⁷⁰

Finally, under federal law certain persons cannot possess or receive any firearms (whether Title I or Title II).¹⁷¹ These excluded individuals include convicted felons, persons either adjudicated a “mental defective” or committed to a mental institution, and persons convicted of misdemeanor domestic violence offenses.¹⁷² However, the list also includes categories that may not be so self-evident, including users of any illegal drug, dishonorably discharged veterans, and persons who have renounced their U.S. citizenship.¹⁷³

¹⁶⁴ See I.R.C. § 5861(d) (requiring the registration of certain particularly dangerous weapons under the NFA); see also *id.* § 5845(a) (listing those weapons that require registration under title 18, section 5861(d) of the U.S. Code).

¹⁶⁵ See I.R.C. § 5861(d). Other federal law prohibits possession of any machine gun not registered with BATFE by May 19, 1986. See 18 U.S.C. § 922(o) (2006). Under the NFA, constructive possession will be treated the same as actual possession. See *U.S. v. Turnbough*, 114 F.3d 1192 (7th Cir. 1997).

¹⁶⁶ See I.R.C. § 5861(e).

¹⁶⁷ See *id.* § 5861(b).

¹⁶⁸ *Id.* § 5812; 27 C.F.R. § 479.84–.85 (2011).

¹⁶⁹ See 27 C.F.R. § 479.85.

¹⁷⁰ I.R.C. § 5845(j).

¹⁷¹ See 18 U.S.C. § 922(d), (g) (2006).

¹⁷² See *id.* § 922(g).

¹⁷³ See *id.* § 922(g)(3), (6)–(7); see also Nathan G. Rawling, *A Testamentary Gift of Felony: Avoiding Criminal Penalties from Estate Firearms*, 23 QUINNIPIAC PROB. L.J. 286

These laws affect how executors carry out everyday tasks. Simple transfers of firearms to satisfy bequests could subject the executor, the heir, or both to criminal penalties.¹⁷⁴ If an executor transfers an NFA weapon to an heir, the transfer is considered as such for NFA purposes. Life gets worse for both the executor and heir if the executor unlawfully transfers an NFA weapon to an out-of-state heir.¹⁷⁵ Appraisals also can be tricky. Appraisers are usually licensed gun dealers. Before returning a weapon, an appraiser may ask the executor to confirm that the executor is lawfully able to possess a firearm. If the executor is not, then the appraiser may not return the weapon.

State and local weapons laws also complicate an executor's job. Several states have assault weapons bans that make it illegal to own some Title I weapons (mostly certain semi-automatic rifles, pistols, and shotguns) that would be legal to possess under federal law.¹⁷⁶ States or localities might further regulate or prohibit ownership of NFA weapons.

What can be done during estate planning to lower the risk of criminal violations? Individuals may purchase NFA weapons in, or transfer NFA weapons to, an entity, such as a corporation, LLC, or revocable trust, to avoid some of the rules that otherwise regulate such transfers. Individuals often opt for trusts because they avoid annual filing fees, public disclosure, or a separate tax return.¹⁷⁷ A revocable trust designed specifically for the ownership, transfer, and possession of an NFA weapon may be known as a gun trust, NFA Trust, Firearm Trust, or Title II Trust.

A carefully drafted gun trust can ease compliance with the NFA laws. As its name implies, a gun trust can be used as the owner of firearms. Each trust must be carefully drafted to account for the different types of firearms that it may hold. The trust can name numerous trustees, each of whom may lawfully possess the weapon without triggering transfer requirements. Once a weapon becomes a trust asset, any beneficiary may use it. Conversely, if an individual owner allowed another individual owner subject to trustee approval to use an NFA weapon not held in a trust, that use could be considered an unlawful transfer subject to criminal penalties. The trust can

(2010) (discussing who may possess firearms, the various restrictions on transfer, and penalties for impermissible transfers).

¹⁷⁴ See 18 U.S.C. § 922(d).

¹⁷⁵ See I.R.C. § 5861(b), (e).

¹⁷⁶ See, e.g., CAL. PENAL CODE § 12280 (West 2009).

¹⁷⁷ David Goldman, an attorney in Jacksonville, Florida is credited with drafting the first gun trust, which he refers to as an NFA firearms trust, in 2007. See Margaret Littman, *In Goldman Guns Trust*, A.B.A. J., Feb. 2011, at 12, 13.

name minor children as its beneficiaries. Moreover, the grantor can be a life beneficiary—although not the sole beneficiary.

Additionally, federal law does not require the NFA trust to submit fingerprints or seek CLEO approval required for individual firearm purchases or transfers (state laws may differ). Instead, the federal government will verify and investigate the application.¹⁷⁸

Of course, to hold a firearm, a revocable trust must include provisions that comply with the NFA. Consulting with an attorney who is experienced in drafting NFA trusts is highly recommended. The NFA registration and transfer requirements for the gun trust are beyond the scope of this article, but be assured that they are numerous. Also, the trustee's power to change the trust name should be limited. Because a firearm is registered in the trust's name in the NFA Registry, a change in trust name would require re-registration of the firearms and payment of a transfer tax.

While not a panacea, gun trusts are most effective with respect to NFA compliance. Persons who are not allowed to buy or own firearms cannot serve as trustees. The trust may not transfer a firearm to a person who may not lawfully buy or own firearms. The transfer of an NFA firearm into a trust or other entity will be subject to a transfer fee. Accordingly, a trustee often purchases NFA weapons directly to avoid the second transfer fee that would accrue if an individual purchaser purchased a weapon and then transferred it to the trust. Also, while the transfer of an NFA weapon to an heir in satisfaction of a bequest is exempt from the transfer tax, the transfer of an NFA weapon to a gun trust is not.

Even with a gun trust, the trustee is responsible for determining the capacity of the beneficiary and the federal, state, and local laws that apply to the individual before allowing a beneficiary to use a trust weapon or distributing an NFA weapon to a beneficiary. Unlike a traditional revocable trust, which can be revoked at any time by the grantor, BATFE must approve termination of the gun trust and distribution of its assets to its beneficiaries as it would any other transfer. Nor may a trustee or beneficiary transport any of the assets across state lines where registered without prior BATFE approval.

As stated above, each state has different laws and local ordinances regulating firearms.¹⁷⁹ Unlike revocable trusts used for general estate planning purposes, trusts used to hold NFA firearms are not necessarily portable.

¹⁷⁸ See 18 U.S.C. § 923 (2006 & Supp. 2010); 28 C.F.R. § 25.1 (2010).

¹⁷⁹ See NFA GUN TRUST LAWYER BLOG, <http://www.guntrustlawyer.com> (last visited Jan. 3, 2011) (compiling applicable state laws).

D. Pet Trusts

Historically, gifts in trust for pets failed because, among other reasons, the gifts, which had no human measuring life, violated the rule against perpetuities.¹⁸⁰ Attempts to circumvent this problem by creating honorary trusts also failed because they lacked a human or legal entity with standing to enforce the trust as a beneficiary. Honorary trusts created great uncertainty for the grantor, who had no assurances that the trust corpus would be used for the trust's intended purpose, because the terms of the gift were predatory in nature and unenforceable.

In 1990, the NCCUSL recognized the importance of pets and the need to have some confidence that pet owners' intent would be carried out with respect to the care of a pet.¹⁸¹ As a result, the Commissioners amended the UPC to validate a "trust for the care of a designated domestic or pet animal."¹⁸² The original amendment allowed the trust to last for a period of twenty-one-years.¹⁸³ That limitation was modified in 1993 to allow adopting states to add a different duration.¹⁸⁴

In 2000, the NCCUSL amended the UTC to add section 408, which specifically allows trusts for animals. Section 408 limits the purpose of a pet trust to care for animals alive during the grantor or testator's lifetime.¹⁸⁵ Additionally, the UTC allows for the appointment of a third party (either a trust protector appointed in the instrument or a guardian *ad litem* appointed by the court) to enforce the terms of the trust.¹⁸⁶ The UTC also addresses the problem of excess funds. If the court determines that the trust property exceeds the amount needed for the intended purpose and that the terms of the

¹⁸⁰ See, e.g., RESTATEMENT (SECOND) OF TRUSTS § 112 (1959) ("A trust is not created unless there is a beneficiary who is definitely ascertained at the time of the creation of the trust or definitely ascertainable within the period of the rule against perpetuities."); Beyer & Wilkerson, *supra* note 139, at 1221–25 (discussing the history of the pet trust); see also Gerry W. Beyer, *Pets Trusts: Fido with a Fortune?* (December 6, 2009), Trusts and Estates Law Section, New York State Bar Association Annual Meeting, January 2010, Texas Tech Law School research paper No. 2010-22, available at <http://ssrn.com/abstract=1519123> (last visited Jan. 3, 2011) (setting forth a comprehensive set of forms, links to all pet trust statutes, and a frequently asked questions section that can be used as a client handout).

¹⁸¹ See Beyer & Wilkerson, *supra* note 139, at 1222.

¹⁸² UNIF. PROBATE CODE § 2-907 (amended 2008), 8 U.L.A. 184 (Supp. 2011).

¹⁸³ See Beyer & Wilkerson, *supra* note 139, at 1222–23.

¹⁸⁴ See *id.*

¹⁸⁵ See UNIF. TRUST CODE § 408(a) (amended 2005), 7C U.L.A. 490 (2006).

¹⁸⁶ See *id.* § 408(b).

trust do not direct the disposition, any excess funds must be held for the benefit of the grantor or the grantor's successors in interest.¹⁸⁷

The UTC and the UPC contain default provisions that, depending upon how a particular state adopts them, govern the administration of a pet trust absent specific requirements in the governing instrument.¹⁸⁸

To date, forty-six states and the District of Columbia have adopted some form of pet trust legislation.¹⁸⁹ In some states, this provision applies only to a specific pet.¹⁹⁰ In others, it applies to descendants as well.¹⁹¹

For example, Washington's Pet Trust Act (WPTA) was passed in 2001 and permits trusts created for the benefit of nonhuman vertebrate animals.¹⁹² WPTA provides that, unless otherwise stated in the trust document, the trust will terminate upon the death of all animals designated as beneficiaries of the trust. Disposal of the remaining trust property occurs either as a part of the testator's residuary estate, if the trust constituted a pre-residuary bequest under a will, or if the trust itself consisted of the residuary estate, to the grantor's then-living heirs.¹⁹³ WPTA permits a person named in the trust instrument, a person appointed by the court, or the person with custody of the animal to enforce the trust for the benefit of the animal beneficiary.¹⁹⁴

The Service has ruled that if a pet trust is valid under applicable state law, then pursuant to Code section 641, the income of such trust would be taxable under section 1(d).¹⁹⁵ As a result, the Service treats income distributed to a caretaker for the care of a pet as the caretaker's taxable income to the extent of DNI.¹⁹⁶ Some practitioners have advocated for the trust to pay the income tax, and others advise trustees to gross up distributions to the caretaker to defray the tax consequence of having to include the distribution in taxable income.¹⁹⁷

The following are a few pet trust drafting recommendations:

¹⁸⁷ See *id.* § 408(c).

¹⁸⁸ See STATE PET TRUST STATUTES, http://www.professorbeyer.com/Articles/Animal_Statutes.htm (last visited Dec. 10, 2011).

¹⁸⁹ See *id.*

¹⁹⁰ See *id.*

¹⁹¹ See *id.*

¹⁹² See WASH. REV. CODE ANN. §§ 11.118.005–.010 (West 2006).

¹⁹³ See *id.* § 11.118.040.

¹⁹⁴ See *id.* § 11.118.050.

¹⁹⁵ See Rev. Rul. 76-486, 1976-2 C.B. 192.

¹⁹⁶ See Beyer & Wilkerson, *supra* note 139, at 1229.

¹⁹⁷ See *id.*

1. Beneficiary of Trust. If substantial sums or valuable animals are involved, specifically identifying the animal that the trust is to benefit is important to avoid the possibility of a different pet benefitting from the trust. A grantor can use photos and a description of unique characteristics included in the document, veterinary records, a tattoo, a microchip, or DNA testing to provide sufficient identification.¹⁹⁸

2. Trustee, Representative Payee, and Caretaker of the Pet. The grantor may want to bifurcate duties, naming a trustee to manage funds and a caretaker to take possession of the pet. In some instances (such as a prize racehorse with extraordinary expenses), the trust will name a third-party as representative payee to receive distributions on behalf of the pet and make disbursements, except for distributions made directly to the caretaker for out-of-pocket expenses or compensation. In other cases, one named individual will fill all three roles. If substantial funds are involved, multiple individuals should divide the labor and allow for a system of checks and balances. In that case, a mechanism for distributions to the caretaker and representative payee should be provided.¹⁹⁹

3. Fiduciaries and Successors. In addition to naming initial fiduciaries and successors, the trust agreement might place certain conditions on their appointment. For example, the agreement could instruct the personal representative to deliver the animal into the caretaker's possession only after obtaining a written promise from the caretaker to provide proper care and an agreement to relinquish the animal to a successor if that promise is not met. The agreement should also name a sanctuary or shelter of last resort in the event that the pet outlives the caretakers or none of the caretakers are able to serve.²⁰⁰

4. Distributions for Proper Care and Reasonable Expenses. The trust agreement should define what proper care means. Proper care could include hiring a full-time caretaker for certain animals, such as farm animals, race horses, and other large or valuable animals.²⁰¹ Reasonable expenses could include food, housing, veterinary and dental care, toys, exercise routines, grooming, compensation for individuals involved in caring for the pet (including walkers), travel, and burial or cremation fees.²⁰² If acupuncture,

¹⁹⁸ See Stephanie B. Casteel, *Estate Planning for Pets*, PROB. & PROP., Nov./Dec. 2007, at 9, 12.

¹⁹⁹ See *id.* at 30.

²⁰⁰ See Rachel A. Hirschfeld, *Estate Planning Strategies for People Who Have Pets*, EST. PLAN., Jul. 2009, at 24, 30.

²⁰¹ See *id.*

²⁰² See *id.*

aromatherapy, massage, and other unusual expenses are regularly incurred and expected to continue, the agreement should describe them in detail.

5. Liability Insurance. The trust agreement may permit the purchase of property and casualty insurance to protect the fiduciaries for damage that the pet may cause to property or individuals.

6. Trust Protector. The grantor should consider a trust protector or a mechanism for the appointment of one. The trust agreement could give a trust protector the power to remove and replace fiduciaries, periodically check on the animal, consult with the pet's health care providers, and review trust financial records. The trust protector might also have the authority to locate an appropriate animal sanctuary if no suitable caretaker can be found.²⁰³ In the absence of a trust protector, both the UPC and the UTC allow for court-appointed oversight of a trust.²⁰⁴

7. Termination of Trust. If permitted under applicable state law, the trust agreement should specify whether the trust will terminate upon the death of the named animals or their offspring. Often, one or more charities may be named. Note, however, that the Service has stated that an otherwise qualified charitable remainder trust for the lifetime of a pet would not qualify as a charitable deduction for the value of the remainder passing to charity.²⁰⁵

8. Reimbursement for Taxes. If the caretaker or representative payee will be subject to additional income taxes as a result of trust distributions, the agreement should specify whether distributions should be grossed-up to account for that additional tax liability.

VI. CONSTRUCTIVE TRUSTS

Despite the use of the term, a constructive trust is not a trust but resembles one; it is an equitable remedy that a court imposes to avoid unjust enrichment when property is in the hands of someone who, in fairness, should

²⁰³ See Casteel, *supra* note 198, at 10.

²⁰⁴ See UNIF. PROBATE CODE § 2-907(c)(7) (amended 2008), 8 pt. 1 U.L.A. 240 (1998); UNIF. TRUST CODE § 408(b) (amended 2005), 7C U.L.A. 490 (2006).

²⁰⁵ See Rev. Rul. 78-105, 1978-1 C.B. 295.

not be allowed to retain it.²⁰⁶ A constructive trust is not a separate cause of action.²⁰⁷

Typically, a constructive trust is a temporary arrangement, under which the trustee's sole duty is to transfer title, possession, or both to the beneficiary or proper owner.²⁰⁸ That the property is in the hands of a third party creates an equitable duty to return the property.²⁰⁹ *Restatement of Restitution* explains:

1. Where a person holding property in which another has a beneficial interest transfers title to the property in violation of his duty to the other, the transferee holds the property subject to the interest of the other, unless he is a bona fide purchaser.
2. Where the owner of property transfers it in fraud of third persons, the transferee holds the property subject to their claims, unless he is a bona fide purchaser.²¹⁰

Evidence of fraud, misrepresentation, bad faith, or overreaching may justify imposing a constructive trust.²¹¹ In *Nelson v. Nelson*, however, the Kansas Supreme Court recently held that if unjust enrichment has clearly occurred, proof of actual or constructive fraud is not necessary.²¹² Courts have also imposed constructive trusts if a party obtains the legal title to real or personal property through undue influence, duress, or even—in some jurisdictions—mistake.²¹³ In some circumstances, “constructive trusts can

²⁰⁶ See *Goodman v. Goodman*, 907 P.2d 290, 293 (Wash. 1995). See generally CONSTRUCTIVE AND RESULTING TRUSTS (Charles Mitchell ed., 2010) (discussing the history of constructive and resulting trusts in English law and various practical and theoretical aspects of the law governing them).

²⁰⁷ See *Nelson v. Nelson*, 205 P.3d 715, 719 (Kan. 2009); *Tupper v. Roan*, 206 P.3d 237, 241–42 (Or. Ct. App. 2009).

²⁰⁸ See *Mattel, Inc. v. MGA Entm't, Inc.*, 616 F.3d 904 (9th Cir. 2010); see also RESTATEMENT OF RESTITUTION: QUASI-CONTRACTS AND CONSTRUCTIVE TRUSTS § 160, cmt. a (1936); DAN B. DOBBS, LAW OF REMEDIES § 4.3(2) (2d ed. 1993).

²⁰⁹ See *Baker v. Leonard*, 843 P.2d 1050, 1055 (Wash. 1993) (quoting *Proctor v. Forsythe*, 480 P.2d 511, 514 (Wash. 1971)).

²¹⁰ RESTATEMENT OF RESTITUTION: QUASI-CONTRACTS AND CONSTRUCTIVE TRUSTS § 168 (1936).

²¹¹ See *Baker*, 843 P.2d at 1054–55.

²¹² See *Nelson*, 205 P.3d at 719.

²¹³ See *Baker*, 843 P.2d at 1054–55 (quoting *Kausky v. Kosten*, 179 P.2d 950 (Wash. 1947)); see also *In re Unicom Computer Corp.*, 13 F.3d 321, 325 (9th Cir. 1994) (imposing a constructive trust over funds of debtor's client that debtor had mistakenly deposited in

arise even when property has been acquired fairly and without any improper means.”²¹⁴ Washington courts have held that “a constructive trust was a proper remedy upon factual situations which constituted something less than actionable fraud.”²¹⁵

A constructive trust can be used creatively when other remedies are not possible. In fact, some courts may consider it as a remedy only if no other remedy is available.²¹⁶ For example, a constructive trust could be used for the following purposes:

1. When title to property has passed to a slayer, and the court has required the property to be held in constructive trust for the proper heirs of the decedent;²¹⁷
2. In bankruptcy, when property has been fraudulently conveyed;
3. In the probate or dissolution context, when an ex-spouse conveys property or dissipates it rather than complying with a property settlement agreement or a contract to make a will;²¹⁸
4. In the probate context, when a trusted person has placed in joint tenancy with right of survivorship to defeat the testator’s estate plan prior to death;
5. In the dissolution situation, when a spouse intentionally has benefited himself at the expense of the marital community;
6. In the business arena, when one person abuses a professional confidential relationship to take financial advantage of another;²¹⁹
7. As a remedy, when there has been a breach of fiduciary duty, including the lawyer–client, doctor–patient, trustee–beneficiary, director–

debtor’s account); *U.S. v. Pegg*, 782 F.2d 1498, 1501 (9th Cir. 1986) (imposing a constructive trust on the purchaser of a vacant lot from U.S. government who mistakenly received, and then sold at a profit, a lot containing a house).

²¹⁴ *Faulknier v. Shafer*, 563 S.E.2d 755, 759 (Va. 2002).

²¹⁵ *Viewcrest Coop. Ass’n, Inc. v. Deer*, 422 P.2d 832, 834 (Wash. 1967).

²¹⁶ *See Tupper v. Roan*, 206 P.3d 237, 241–42 (Or. Ct. App. 2009).

²¹⁷ *See, e.g., Kelley v. State*, 196 A.2d 68, 71 (N.H. 1963); *Hargrove v. Taylor*, 389 P.2d 36, 39 (Or. 1964).

²¹⁸ *See Murphy v. Glenn*, 964 P.2d 581, 586–87 (Colo. App. 1998) (discussing a constructive trust imposed on a revocable trust which violated the terms of a contract to make a will).

²¹⁹ *See Mattel, Inc. v. MGA Entm’t, Inc.*, 616 F.3d 904, 910–11 (9th Cir. 2010) (vacating the lower court’s use of a constructive trust to award Mattel all rights over all trademarks relating to MGA’s *Bratz*-branded products, but acknowledging that in certain circumstances this could be an appropriate remedy).

corporation, agent–principal, partner–partner, employee–employer, or clergy–parishioner relationship;²²⁰ and

8. In the charitable realm, when a charitable gift results in the creation of a fiduciary relationship, but the donor expresses no clear direction or obligation.²²¹

While the statute of frauds and parol evidence rules are not necessarily impediments to the imposition of a constructive trust, one should keep them in mind when seeking this remedy under the applicable state law.²²² Not all states bar testimony regarding the intentions of a deceased party.²²³ Because a constructive trust is not necessarily a remedy based on intent, but a way of remedying unjust enrichment, the testimony of a deceased third party is not necessary to compel its application.

VII. TRUSTS THAT DEFY CATEGORIZATION

Some trusts defy categorization. They are at once hybrids of the traditional express trust and the commercial trust but do not qualify as either. They also have overtones of the purpose trust and the constructive trust. This section discusses these hybrids.

A. Blind Trusts

Individuals frequently use a blind trust when they wish to retain certain investments but find it necessary or desirable to strictly limit their knowledge of how the assets are being managed. Public officials commonly use blind trusts to avoid actual or apparent conflicts of interest.²²⁴ Business executives might also use blind trusts if they would otherwise be unable to deal with interests in the companies they manage without violating certain fiduciary or ethical obligations or without running afoul of securities laws.²²⁵

²²⁰ See Beth Nosworthy, *Fiduciary Obligations and the Remedial Constructive Trust* (Nov. 4, 2010) (unpublished manuscript), available at <http://ssrn.com/abstract=1887945>.

²²¹ See Megan Loving, *An Arm and a Van Gogh: Selling Art Collections from Charitable Contributions for Capital Gain is a High Price to Pay*, 1 *EST. PL. & COMMUNITY PROP. L.J.* 455, 466–67 (2009).

²²² See David W. Kirch, *Constructive Trusts*, *TR. & EST.*, Jul. 2007, at 50, 53.

²²³ See *id.*

²²⁴ See Megan J. Ballard, *The Shortsightedness of Blind Trusts*, 56 *U. KAN. L. REV.* 43, 44 (2007).

²²⁵ See *id.* at 46–47.

1. *Blind Trusts for Public Officials*

A public official has an obligation to exercise the powers of office in the best interest of the public. As the Supreme Court articulated, “an impairment of impartial judgment can occur in even the most well-meaning men when their personal economic interests are affected by the business they transact on behalf of the Government.”²²⁶ In carrying out their duties, public officials may make decisions that will be either beneficial or detrimental to their personal investments and assets. While an official can avoid these conflicts by public disclosure and selling or otherwise disposing of all such investments and assets before taking office, disposition, disclosure, or both may not always be desirable or possible. In those cases, officials can use a blind trust to reduce or eliminate concerns over a conflict of interest.

Blind trusts established for the benefit of officials in the three branches of the federal government must comply with rules promulgated under the Ethics in Government Act of 1978 (1978 Act).²²⁷ If a trust complies with the requirements of the 1978 Act and its related regulations, the official may be exempt from certain disclosure requirements. The Office of Government Ethics (OGE) issued regulations under the 1978 Act explaining the basic policy considerations and objectives of a blind trust:

If Government employees do not know the exact identity, nature, and extent of their financial interests, then the employees cannot be influenced in the performance of their official duties by those interests. . . . Therefore, the most significant objective to be achieved through the use of a blind trust is the lack of knowledge, or actual “blindness,” by a Government official with respect to the holdings in his trust. The same goal may be achieved through the use of a diversified trust.²²⁸

²²⁶ U.S. v. Mississippi Valley Generating Co., 364 U.S. 520, 549 (1961).

²²⁷ See Ethics in Government Act of 1978, Pub. L. No. 95-521, 92 Stat. 1824 (1978) (codified at 5 U.S.C. App. §§ 101–111, 401–408, 501–505 (2006)); see also Edmond M. Ianni, Fiduciary Firewalls: A Look at Blind Trusts, 37th Annual Philip E. Heckerling Institute on Estate Planning, University of Miami Law Center (Jan. 9, 2003) (providing a thorough analysis of this topic, as well as public and private sector forms); Edmond M. Ianni, *Blind Trusts Offer Clients Customized Wealth Planning*, EST. PLAN., Jul. 2003, at 319, 328; Susan M. Hughes & Thomas G. Opferman, *So Your Client Wants To Be in Government*, TR. & EST., Nov. 2004, at 18, 19; Ballard, *supra* note 224, at 49.

²²⁸ 5 C.F.R. § 2634.401(b)(1) (2011).

While prior guidelines to prevent unethical behavior and conflicts of interest by politicians existed, Watergate prompted Congress to enact rules requiring certain legislative, executive, and judicial personnel at the federal level to periodically file detailed financial and conflict of interest reports.²²⁹

The 1978 Act requires certain government employees and officials to submit financial disclosure statements—which differ by branch—that are open to review by the public.²³⁰ Those required to report are referred to as “reporting individuals” and include the President, Vice-President, high-level employees of the executive branch, administrative law judges, members of Congress, high-level congressional officers and employees, federal judges, and federal judicial employees authorized to perform adjudicatory functions.²³¹

Reporting individuals must disclose all sources and amounts of income, as well as other assets owned and their values.²³² In general, when reporting individuals have knowledge of a matter related to their interest, they will be disqualified from participating in that matter professionally.²³³

Several offices monitor the conflict of interest laws and blind trusts, including the OGE, an independent executive agency that monitors the executive branch; the House Committee on Standards of Official Conduct, which oversees blind trusts for members of the U.S. House of Representatives and House officers and employees; and the Senate Select Committee on Ethics, which monitors Senators and Senate officers and employees.²³⁴

The following discussion focuses on the two types of qualified trusts authorized by the OGE for the executive branch—the qualified blind trust and the qualified diversified trust. The approach of the other branches is substantially similar.

The qualified diversified trust—a trust that the Director of the OGE has certified and that holds a diversified portfolio managed by an independent trustee and containing provisions the OGE has prescribed—is exempt from the 1978 Act disclosure rules.²³⁵ Investing in the short list of permitted assets may not be financially practical, however, because such investments

²²⁹ See Ballard, *supra* note 224, at 55–56 (describing a sometimes sordid history of the precursors to the blind trust).

²³⁰ See 5 U.S.C. App. § 101 (2006).

²³¹ See *id.* § 101(f)(1)–(12); see also Ballard, *supra* note 224, at 50–51.

²³² See 5 U.S.C. App. § 102(a)(1)(A).

²³³ See 5 C.F.R. §§ 2640.103(d), 2634.401–409 (2011).

²³⁴ See Ballard, *supra* note 224, n.47 and accompanying text.

²³⁵ See 5 U.S.C. App. § 102(f)(4)(B).

must be disclosed on annual financial reports. The trust is only diversified if the trust's assets consist of a widely diversified portfolio of readily marketable securities and do not initially include the securities of any entities having substantial activities in the same area as the official's primary area of responsibility.

A qualified blind trust is blind only with respect to assets about which no interested party—generally, the reporting individual, his spouse, and his minor or dependent children—has knowledge.²³⁶

An employee is not required to separately identify assets held in qualified blind trusts on their annual disclosure. Rather, the employee reports the trust value and its projected income as a range.²³⁷

A qualified blind trust must satisfy a number of requirements including the following:

1. The trust instrument and the trustee must receive prior approval from the appropriate supervisory ethics office;²³⁸

2. The executed agreement, a list of all assets transferred to the trust, and their values must be filed within thirty days of execution;²³⁹

3. Assets initially transferred to the trust are tainted permanently. Because an official has knowledge of the assets originally placed in trust, original assets continue to be subject to various conflict of interest restrictions until the trustee notifies the official either that a particular original asset has been disposed of or that its value is less than \$1,000;²⁴⁰

4. The trustee must qualify as an independent trustee, as defined in title 5, section 102(f)(3)(A) of the U.S. Code;

5. With limited exceptions, the trustee must receive permission to sell or dispose of any assets initially transferred to the trust;²⁴¹

6. The trust instrument must limit communication between a trustee and an official or other interested party. The 1978 Act permits three types of communication: the general financial needs of the interested party or a written direction to the trustee to sell an asset initially put in the trust, if it is later determined to actually or potentially create a conflict of interest; quarterly trustee reports concerning the trust's total value, net income and loss, and any other information that enables the interested party to complete per-

²³⁶ See *id.* § 102(f)(3)(C)(vi).

²³⁷ See *id.* § 102(f)(2)(A).

²³⁸ See *id.* § 102(f)(3)(D).

²³⁹ See *id.* § 102(f)(5)(A).

²⁴⁰ See *id.* § 102(f)(4)(A).

²⁴¹ See *id.* § 102(f)(3)(B).

sonal tax returns and financial disclosure reports; and when the trustee transfers out an asset initially put into the trust;²⁴²

7. The Attorney General is authorized to bring civil actions in any appropriate U.S. District Court for violations of the rules governing qualified blind trusts.²⁴³

The trust instrument for each type of trust must also contain certain provisions that carry out the policy and objectives described above. These provisions can be found in the Model Qualified Blind Trust Provisions,²⁴⁴ Model Qualified Diversified Trust Provisions,²⁴⁵ and the model agreement of the Senate Select Committee on Ethics.²⁴⁶ Executive branch qualified blind trusts are subject to an additional set of regulations that do not apply to legislative blind trusts.²⁴⁷

In 1980, the Service established conditions under which a trustee of certain blind trusts could file an income tax return on behalf of eligible beneficiaries;²⁴⁸ it modified these conditions in 2010.²⁴⁹ Under the prior rules, the Service required the trustee to obtain advance written permission from the Service to file a federal income tax return on behalf of a beneficiary, which the trustee could then file if accompanied by a copy of the written authorization and a power of attorney.²⁵⁰ Under the new rules, the Service has eliminated the requirement that the beneficiary receive advance permission for the trustee to file the income tax return on behalf of the blind trust.²⁵¹

Many states have statutes that prescribe requirements for blind trusts established for state officials.²⁵² These vary by jurisdiction but generally are based on the approach of the OGE model. Thus, the OGE model should be

²⁴² See *id.* § 102(f)(3)(C)(iii).

²⁴³ See *id.* § 102(f)(6)(C).

²⁴⁴ See Office of Gov't Ethics, Model Qualified Blind Trust (Mar. 2002), <http://www.usoge.gov/ethicsdocs/publications/modeltrustdocs.apcx>.

²⁴⁵ See Office of Gov't Ethics, Model Qualified Diversified Trust Provisions (Mar. 2002), <http://www.usoge.gov/ethicsdocs/publications/modeltrustdocs.apcx>.

²⁴⁶ See Senate Select Comm. on Ethics, Model Agreement (Dec. 2010), <http://ethics.senate.gov/downloads/pdffiles/trust.pdf>.

²⁴⁷ See 5 C.F.R. §§ 2634.403–.408 (2011).

²⁴⁸ See Rev. Proc. 80-59, 1980-2 C.B. 855 (requiring “that the letter granting permission for the trustee to make the appointee’s return and a power of attorney both accompany the appointee’s income tax return”).

²⁴⁹ See Rev. Proc. 2010-11, 2010-2 I.R.B. 269.

²⁵⁰ See Rev. Proc. 80-59, 1980-2 C.B. 855.

²⁵¹ See Rev. Proc. 2010-11, 2010-2 I.R.B. 269.

²⁵² See, e.g., MISS. CODE ANN. § 25-4-28 (West 2010).

consulted when establishing a blind trust for an individual who holds public office at the state level.

While Washington does not statutorily provide for a blind trust, its Revenue Code sets forth a list of permissible investments similar to those permitted by a qualified diversified trust.²⁵³ The statute further provides that:

[E]xcept for permissible investments as defined in this section, no state officer or state employee of any agency responsible for the investment of funds, who acts in a decision-making, advisory, or policy-influencing capacity with respect to investments, may have a direct or indirect interest in any property, security, equity, or debt instrument of a person, without prior written approval of the agency.²⁵⁴

Section 390-24-010 of the Washington Administrative Code provides that the official form for statements of financial affairs as required by section 42.17.240 of the Revised Code of Washington is Form F-1, which requires a beneficiary to report trust income but not trust assets.²⁵⁵ Thus, a blind trust containing the appropriate screen between the trustee and the beneficiary is effective in allowing certain individuals to own a broader range of investments than those otherwise permitted by section 42.52.190.

2. *Blind Trusts for Business Executives*

Business executives often encounter situations in which they must act in the best interests of shareholders or other business owners. Therefore, they may be unable to freely deal with their personal investments or assets for fiduciary, ethical, or statutory reasons. Additionally, a blind trust is often necessary when securities law imposes restrictions on the purchase and sale of public company securities.

Securities law prohibits insider trading—buying or selling securities of a public company based on material nonpublic information.²⁵⁶ Officers, di-

²⁵³ See WASH. REV. CODE ANN. § 42.52.190(3) (West 2006).

²⁵⁴ *Id.* § 42.52.190(1).

²⁵⁵ See *Washington State Public Disclosure Commission Personal Financial Affairs Statement Instruction Manual*, <http://www.pdc.wa.gov/archive/filerassistance/manuals/pdf/2009/2010ManF1.pdf> (last visited Jan. 5, 2011) (supplementing the rules set forth in subchapter 42.17 of the Revised Washington Code and title 390 of the Washington Administrative Code and providing the applicable forms required for compliance).

²⁵⁶ See Securities Exchange Act of 1934, Pub. L. No. 73-291, § 10, 48 Stat. 891 (codified at 15 U.S.C. § 78 (2006)); see also 17 C.F.R. § 240.10 (2011).

rectors, and other executives of public companies frequently come into possession of this information because of their positions within a company. For example, they are likely to learn about a pending acquisition involving a company long before the information becomes generally known to the public. Public companies wishing to facilitate purchases and sales of their securities by executives frequently designate fixed quarterly “open window” periods during which the executives can freely buy and sell the securities without running afoul of the prohibition against insider trading (assuming the executive does not actually possess material inside information about his company).²⁵⁷ The open window period generally begins after the company has released information on quarterly or year-end earnings and ends well in advance of the next release of earnings information.

While open window periods alleviate some of the concerns caused by restrictions on insider trading, an executive may desire more flexibility in terms of when she can buy or sell securities or may not be able to take advantage of the open window periods because she actually possesses material inside information. In either situation, a blind trust can avoid an actual or apparent conflict of interest. The U.S. Securities and Exchange Commission has stated:

[W]e do not believe this trading [*i.e.*, by a blind trust] creates difficulties under existing insider trading law. When a person places securities in a blind trust, by definition he or she does not make the decisions to purchase or sell securities in that account. Therefore, those trading decisions (which are made by the trustee of the blind trust) should not be attributed to the person for purposes of potential insider trading liability.²⁵⁸

The rules relating to blind trusts for public officials, discussed above, are useful guidelines when establishing a blind trust for a business executive.

The trust should have an independent trustee. The trust agreement should give the trustee discretion to purchase and divest the trust of shares in the public company pursuant to a set of general guidelines or a policy set forth in a written plan that is established when the executive is not in possession of material nonpublic information. After establishing the blind trust,

²⁵⁷ See 17 C.F.R. § 240.10b5-1 (2011).

²⁵⁸ Selective Disclosure and Insider Trading, 64 Fed. Reg. 72,590, 72,601 (proposed Dec. 28, 1999).

the executive and the trustee must strictly limit communications concerning the public company and minimize the potential for insider trading and other prohibited actions based on ownership of a particular asset.

Like Washington, Delaware does not have a statute specifically requiring or governing the existence of a blind trust. However, Delaware is often chosen as the situs for the blind trusts because of the statutory protections and advantages available under state law, including asset protection features not available for self-settled trusts in most states.²⁵⁹

B. Coogan Trusts

Statutory trusts even exist for child actors. These trusts are known as Coogan trusts, and California, the home of Hollywood, passed the first statute allowing them. The Coogan trust is named for the famous child actor Jackie Coogan.²⁶⁰ Charlie Chaplin discovered Coogan in 1919 and cast him in his movie, *The Kid*. Coogan later became well-known as Uncle Fester on *The Addams Family*. Only after his twenty-first birthday, the death of his father, and the dwindling of his film career, did Jackie realize that his parents had saved very little of his earnings. Under California law at the time, the earnings of the minor belonged solely to the parent.

Coogan eventually sued his mother and his former manager and recovered a small portion of his earnings. As a result, in 1939, the earliest version of the California Coogan Law, which has been amended many times, was passed to protect future young actors from financial exploitation.

Coogan trust accounts are essentially blocked trust accounts and are required for child actors in California,²⁶¹ New York,²⁶² Louisiana,²⁶³ and New

²⁵⁹ See DEL. CODE ANN. tit. 12, §§ 3570–3576 (2007).

²⁶⁰ For a biography of Jackie Coogan, see DIANA SERRA CARY, JACKIE COOGAN: THE WORLD'S BOY KING: A BIOGRAPHY OF HOLLYWOOD'S LEGENDARY CHILD STAR (2007). For a detailed history of the laws protecting child performers from financial exploitation, see Marc R. Staenberg & Daniel K. Stuart, *Children as Chattels*, <http://www.minorcon.org/childrenaschattels.html> (last visited Dec. 10, 2011).

²⁶¹ See CAL. FAM. CODE §§ 6750–6753 (West 2004).

²⁶² See N.Y. EST. POWERS & TRUSTS LAW § 7-7.1 (McKinney Supp. 2011). As long as the Child Performer trust account meets the standards required by the New York State Uniform Transfer to Minors Act or New York Uniform Gift to Minors Act, it does not matter where the account is actually located. A Uniform Transfer to Minors Act or Uniform Gift to Minors Act trust account located in a state other than New York State could satisfy the requirements for a New York State Child Performer trust account, and transfers could be made into such an account. However, a trust company must be appointed as custodian of the account when the balance reaches \$250,000.

Mexico.²⁶⁴ Because California's laws are the most restrictive in protecting Coogan trusts, it is generally recommended that parents establish an account in California for a child actor who they anticipate will accrue earnings in multiple states.

California's Coogan law applies to the earnings of a minor who is employed to render athletic, artistic, or creative services.²⁶⁵ If approved by the court, an otherwise valid contract cannot be disaffirmed because of a party's minority.²⁶⁶ The following rules apply to contracts approved by the court (similar rules apply to those contracts not approved by the court). In court-approved contracts, 15% of a minor's gross wages are required to be withheld by the employer and deposited into the Coogan trust account within twenty-five business days of employment.²⁶⁷ A parent, guardian, or other trustee must supply the employer with the Coogan account information within ten business days of employment.²⁶⁸

The trustee must open the Coogan trust account at a financial institution or a company in California that is insured by the Federal Deposit Insurance Corporation, the Securities Investor Protection Corporation, the National Credit Union Share Insurance Fund, or in a company registered under the Investment Company Act of 1940.²⁶⁹

A court may appoint the minor's custodial parent or legal guardian as trustee of the Coogan trust account, unless the court determines that the appointment of a different individual or entity would be in the best interest of the minor.²⁷⁰ As indicated above, the minor's employer must deposit 15% of the minor's gross earnings into the Coogan trust account (unless a court orders more than 15% be deposited into the trust account).²⁷¹ The trustee holds the funds in the Coogan trust account until the minor turns eighteen,

²⁶³ See LA. REV. STAT. ANN. §§ 51:2131–2135 (Supp. 2011) (requiring parents to open a blocked trust account with any bank in any state).

²⁶⁴ See N.M. STAT. ANN. § 50-6-19 (LexisNexis Supp. 2011) (requiring parents to open a blocked trust account only if their child earns more than \$1,000 per each employment contract).

²⁶⁵ See CAL. FAM. CODE § 6750(a)(1) (West 2011) (outlining how artistic or creative services include, but are not limited to, actors, dancers, musicians, comedians, singers, stuntpersons, voice-over artists, songwriters, composers, and conductors).

²⁶⁶ See *id.* § 6751.

²⁶⁷ See *id.* § 6752(b)(1), (3)–(4).

²⁶⁸ See *id.* § 6752(b)(3).

²⁶⁹ See *id.* § 6753.

²⁷⁰ See *id.* § 6752(b)(2).

²⁷¹ See *id.* § 6752(b)(7).

and no one may withdraw from the account without a court order (except to transfer funds to another qualified financial institution) for the term of the trust.²⁷²

If a parent, guardian, or other trustee fails to provide the minor's employer with a trustee's statement within one hundred eighty days after the start of employment, the employer must forward the funds that would otherwise go into the trust account to the Actors Fund of America.²⁷³ In that case, the Actors Fund of America acts as trustee of the funds until the parent, guardian, or other trustee provides the trustee statement, the minor turns age eighteen, or the minor becomes an emancipated adult.²⁷⁴

Coogan laws still leave child actors vulnerable to exploitation by their employers, managers, parents, and guardians. Parents and employers can forum shop for the state with the least restrictive child labor laws. Due to the timing of the application of current laws to longer term contracts, most child actors who work under short term agreements for commercials or single television show appearances do not fall under the law's coverage. Reality shows dominate much of television programming, and children, whose parents thrust them into these shows, are not subject to Coogan laws because they are not considered actors or entertainers.²⁷⁵ Unless a parent, guardian, or employer seeks court approval of a contract, the court will be unaware of the arrangement, and therefore the child actor's contracts and earnings will be outside the system meant to regulate and protect them.

Although Coogan laws have weaknesses, child actors and entertainers in states without them and without other statutes that specifically protect against financial exploitation lack even the slim protections that a Coogan law would otherwise provide.

C. Totten Trusts

Totten trusts are payable-on-death accounts but are considered to be informal revocable trusts until the death of the depositor. The name is derived from *Matter of Totten*,²⁷⁶ which acknowledged that an account holder may sign a bank's signature card designating that, upon the account holder's death, the remaining deposits are to be paid to one or more named benefi-

²⁷² See *id.* § 6753(b).

²⁷³ See *id.* § 6752(b)(9)(A).

²⁷⁴ See *id.* § 6752(b)(9)(c).

²⁷⁵ See Eric Felten, *The Kids Stay In the Picture—Sadly Enough*, WALL ST. J., Oct. 23, 2009, at W13.

²⁷⁶ 71 N.E. 748 (N.Y. 1904).

ciaries.²⁷⁷ During her lifetime, the depositor may be the grantor, the trustee, and the beneficiary. The contingent beneficiary is named on the signature card but has no rights until the death of the depositor, who can revoke the designation at any time.²⁷⁸

D. IOLTA and IRETA Accounts

Like Totten Trusts, interest on lawyer's trust account (IOLTA) and interest on real estate agent trust account (IRETA) accounts are bank accounts set up as informal trusts. The funds held in these accounts ultimately belong to the individuals or businesses that do business with the attorney (in the case of IOLTA accounts) or real estate settlement companies and brokers (in the case of IRETA accounts). An IOLTA account is a type of trust account lawyers use to temporarily hold funds for a client; for example, pending settlement or until a check clears.²⁷⁹ By statute, these accounts must be interest bearing.²⁸⁰ Interest on IRETA accounts is paid to the Washington State Department of Licensing.

Every state has a form of lawyer trust account and IOLTA rules.²⁸¹ Washington's lawyer trust account rule imposes a strict fiduciary standard that all funds that a lawyer receives and that belong wholly or in part to a client or third person must be maintained in an interest-bearing trust account while in the lawyer's possession.²⁸² The lawyer must segregate the trust account from the lawyer's other funds.²⁸³ Only financial institutions that are insured by the Federal Deposit Insurance Corporation or the National Credit Union Administration and that are authorized to do business within the state may maintain a lawyer trust account.²⁸⁴ Washington Rule of Professional Conduct 1.15B imposes a standard by which lawyers must keep account records.

Finally, and most importantly for this discussion, the trust account must generate interest for the benefit of either the client or a specified charity (in which case it is not simply a lawyer trust account, but an IOLTA ac-

²⁷⁷ See RESTATEMENT (THIRD) OF TRUSTS § 26 (2003); *see also* RESTATEMENT (THIRD) OF PROPERTY § 7.1 cmt. (2001) (acknowledging the validity of a Totten trust).

²⁷⁸ See *Araiza v. Younkin*, 116 Cal. Rptr. 3d 315, 319 (Ct. App. 2010).

²⁷⁹ See, e.g., WASH. REV. CODE ANN. R.P.C. 1.15A–B (West 2009).

²⁸⁰ See, e.g., *id.* R.P.C. 1.15A.

²⁸¹ For a directory of IOLTA account programs in the U.S., see http://www.americanbar.org/groups/interest_trust_accounts/resources/directory_of_iolta_programs.html.

²⁸² See WASH. REV. CODE ANN. R.P.C. 1.15A(h)(9)(i).

²⁸³ See *id.* R.P.C. 1.15A(c).

²⁸⁴ See *id.* cmt. 18.

count).²⁸⁵ In every state, interest on an IOLTA account is used for the public good—typically for legal services for the indigent or low-income individuals within the state.²⁸⁶

In states that have IRETA accounts, such as Washington, any real estate broker who receives funds or moneys from any principal or any party to certain real estate transactions shall hold the funds or moneys in a trust account.²⁸⁷ Under certain circumstances that vary by state, the account must

²⁸⁵ See 12 U.S.C. § 1832(a)(2) (2006).

²⁸⁶ In Texas, for example, interest is remitted to Texas Equal Access to Justice Program. See TEX. GOV'T CODE ANN., tit. 2, subtit. G, app. A, art. XI, §§ 6–7 (West 2005). In Washington, the interest is remitted to the Legal Foundation of Washington to cover the payment for civil legal services for the indigent. Washington IOLTA accounts must be administered pursuant to further regulations, as required by Washington Rules for Enforcement of Lawyer Conduct Rules 15.4 and 15.7. The Washington State Bar Association has published a guide to lawyers for maintaining client trust accounts, entitled *Managing Client Trust Accounts: Rules, Regulations and Common Sense*. See <http://www.legalfoundation.org/sites/legalfoundation/upload/filemanager/IOLTA/Managing-Client-Trust-Accts-2007.pdf>.

²⁸⁷ See WASH. ADMIN. CODE § 308-124E-110 (2010) (providing, in part, that:

The procedures in this section are applicable to funds received by the firm in connection with real estate sales, business opportunity transactions or options. These procedures are in addition to the requirements of the general trust account procedures contained in WAC 308-124E-105.

(1) Bank accounts, deposit slips, checks and signature cards shall be designated as trust accounts in the firm or assumed name as licensed. Trust bank accounts for real estate sales or business opportunity transactions shall be interest bearing demand deposit accounts. These accounts shall be established as described in RCW 18.85.285 and this section. (a) The firm shall maintain a pooled interest-bearing trust account identified as housing trust fund account for deposit of trust funds which are ten thousand dollars or less. Interest income from this account will be paid to the department by the depository institution in accordance with RCW 18.85.285(8) after deduction of reasonable bank service charges and fees, which shall not include check printing fees or fees for bookkeeping systems. (b) The licensee shall disclose in writing to the party depositing more than ten thousand dollars that the party has an option between (b)(i) and (ii) of this subsection: (i) All trust funds not required to be deposited in the account specified in (a) of this subsection shall be deposited in a separate interest-bearing trust account for the particular party or party's matter on which the interest will be paid to the party(ies); or (ii) In the pooled interest-bearing account specified in (a) of this subsection if the parties to the transaction agree in writing).

Wisconsin refers to IRETA accounts as Interest Bearing Common Trust Accounts. See WIS. STAT. ANN. 452.13(2) (West 2006); WIS. ADM. CODE Comm. ch. 155 (2006).

qualify as an IRETA account. Interest on an IRETA account is remitted to the state, which holds it for particular charitable programs designated by state law.²⁸⁸

At the time of writing, the unlimited federal deposit insurance program of the Federal Deposit Insurance Corporation's Temporary Liquidity Guaranty Program covered IOLTA, but not IRETA, accounts.

E. Trusts That Are Void Per Se

Trusts purporting to carry out a purpose that violates public policy are void per se.²⁸⁹ Unlike a trust that violates public policy but otherwise meets the definition of a trust, a document that claims to create a trust but in substance does not change the grantor's control or beneficial interest in the underlying assets purportedly transferred to the trustee is a sham and is no trust at all.²⁹⁰ Sham trusts take on many formats but frequently involve multiple foreign and domestic trusts and entities, which often hold interests in other trusts.²⁹¹ Foreign trusts are commonly located in a country that has no tax treaty agreement for the exchange of information with the U.S. government. Funds may flow from one trust to another by way of management agreements, rental agreements, fees for services, purchase and sale agreements, and distributions. Sham trusts often lack named beneficiaries; instead, units or certificates of beneficial interests that entitle the holder to certain distribution rights with respect to the trust income represent the interests of beneficiaries. Frequently, sham trusts also include a purpose stated in religious or moral terms, based on patriotic principles, or based on the grantor's purported constitutional rights.

²⁸⁸ In Washington, state law provides that such funds, net of any reasonable fees, shall be "to the state treasurer for deposit in the Washington housing trust fund created in RCW 43.185.030 and the real estate education program account created in RCW 18.85.321." WASH. REV. CODE ANN. § 18.85.285(8)(B). Wisconsin uses interest on Interest Bearing Common Trust Accounts to augment existing emergency and transitional homeless programs by funding grants to organizations that provide shelter or services to homeless individuals or families. See WIS. ADMIN. CODE § Comm. 155.03.

²⁸⁹ See RESTATEMENT (THIRD) OF TRUSTS § 29 (2003).

²⁹⁰ When the establishment of trusts has no real economic effect, the substance of the transactions involving the trusts will control over the form. See *Zmuda v. Comm'r*, 731 F.2d 1417, 1421 (9th Cir. 1984), *aff'g* 79 T.C. 714 (1982); *Markosian v. Comm'r*, 73 T.C. 1235, 1245 (1980). This is true even if the entity has a separate legal existence recognized under state law. See *Furman v. Comm'r*, 381 F.2d 22, 22 (5th Cir. 1967) (per curiam), *aff'g* 45 T.C. 360 (1966).

²⁹¹ See IRM § 4.32.2.14.1 (Mar. 30, 2006).

Sham trusts go by any number of names, including pure trusts, constitutional pure equity trusts, contract trusts, freedom trusts, unincorporated business trusts, equipment trusts, service trusts, final trusts, common law trust organizations, and foreign common law trust organizations. The promoters of many sham trusts market them as proprietary products, often as part of multilevel marketing or Ponzi schemes. The unifying factor is that sham trusts promise tax benefits without any actual change in ownership or control of the taxpayer's property or income.

Neither courts nor state and local income tax authorities recognize sham trusts. In Notice 2008-14, the Service announced that it will actively examine certain trust arrangements that purport to reduce or eliminate federal income taxes in ways that are legally impermissible.²⁹²

Promoters make some of the following claims about sham trusts:

1. They are merely contracts between a grantor and a trustee and are not taxable under Article 1, Section 10 of the U.S. Constitution, which provides that “[n]o state shall pass any law impairing the obligations of contracts.” Code section 61 and the Sixteenth Amendment to the U.S. Constitution empower Congress to tax income from whatever source derived.²⁹³
2. The trust can eliminate or reduce income, estate, gift, and self-employment taxes, and the transfer to the trust is not a taxable gift.²⁹⁴
3. Filing tax returns is voluntary, and only those individuals or businesses that voluntarily disclose personal information on a tax return are subject to tax. Trusts cannot be compelled to disclose books and records to the Service.²⁹⁵
4. Property held by the trust is exempt from seizure by the Service.
5. A trust may deduct substantially all living expenses, including housing, automobiles and repair,

²⁹² See Notice 2008-14, 2008-1 C.B. 310.

²⁹³ See *Steve Leimberg's Estate Planning Email Newsletter-Archive Message 1606*, LEIMBERG INFO. SERV., INC. (Feb. 17, 2010) (on file with author).

²⁹⁴ See *id.*

²⁹⁵ *Contra Porth v. Brodrick*, 214 F. 2d 925 (10th Cir. 1954) (rejecting claims that bookkeeping and maintenance of records is involuntary servitude).

groceries, clothing, and entertainment as a business expense.²⁹⁶

6. The trust permits depreciation of a personal residence and furnishings.

7. Trust assets are permitted a stepped-up basis upon funding.

One arrangement involves the grantor's purported assignment of his lifetime services to the trust.²⁹⁷ The trust enters into a service contract with the grantor's employer, under which the trust provides services to the employer in exchange for a monthly fee equal to the amount of the grantor's salary. The claim is that because the payments are made pursuant to a contract for services, no withholding or employment taxes are owed. *Lucas v. Earl*²⁹⁸ states that this arrangement fails because it violates the well-known income tax rule that income is taxed to the individual who earns it.²⁹⁹

A foreign tax haven double trust is a scheme according to which a taxpayer purports to have no control over a business transferred to either a domestic or offshore trust, but in fact retains the same level of control as existed prior to the transfer.³⁰⁰ This kind of scheme is marketed as follows: The taxpayer purports to transfer his business to the trust (one trust may own the daily operations and another may own the equipment, which it leases back to the operations trust at inflated rates equal to its income). This leaves no income subject to tax in the first trust. The taxpayer is, therefore, purportedly no longer in control of the business or the assets. Next, the income from the equipment trust is distributed to a foreign trust. The first foreign trust then distributes all or most of its income to a second foreign trust. Because the second trust's income is foreign-based, the trustee claims not to have a filing requirement. Once the assets are in the second foreign trust, a

²⁹⁶ *Contra* U.S. v. Schmidt, 935 F.2d 1440, 1449 (4th Cir. 1991) (holding that transferring one's personal assets to a trust does not cause them to become business assets or their related expenses deductible business expenses).

²⁹⁷ *See, e.g.*, U.S. v. Buttorff, 761 F.2d 1056, 1060 (5th Cir. 1985).

²⁹⁸ 281 U.S. 111 (1930).

²⁹⁹ *See id.* at 111; *see also* Chase v. Comm'r, 926 F.2d 737, 740 (8th Cir. 1991) (upholding tax court ruling that when services are assigned pursuant to a contract, that contract is ineffective as a means to avoid the employee's tax obligations, FICA, or withholding requirements).

³⁰⁰ *See, e.g.*, Rev. Rul. 80-74, 1980-1 C.B. 137; *see also* Complaint, United States v. Hatcher, No. 09-CV-14263-Graham-Lynch, (S.D. Fla. Aug. 3, 2009), *available at* http://www.justice.gov/tax/BHatcher_Complaint.pdf.

bank account is opened either under the trust name or an entity often referred to as an international business corporation.

The Service has indicated a continuing effort to prosecute sham trust promoters and taxpayers who use them to avoid paying taxes owed, and has specifically included sham trusts in its annual “Dirty Dozen” watch list of tax scams for many years.³⁰¹ The *Internal Revenue Service Manual Examination Guidelines* for potentially abusive trusts provide a useful summary for clients about the ways in which something that looks too good to be true likely is not true at all. The seven issues meriting closer scrutiny are as follows:

1. Examiners must pay special attention to trusts using “Promoters” who market potential abusive tax schemes.
2. Special interest should be paid to trusts operating in a “multi-tier” system organized and operated to avoid tax.
3. The examiner must check to see if the creator of a [non-exempt charitable trust] assigns . . . income to the trust, never giving up “control” of the income or assets.
4. The examiner should verify that [non-exempt charitable trusts] are not paying the personal expenses of the creator or trustee and labeling these expenses as “management service fees” or deducting them as some other expense.
5. For [non-exempt charitable trusts] [i]f the taxpayer was required to, but did not file Form 1041-A, consider assessing penalties per IRC § 6652(c)(2).
6. In the case of [charitable remainder trusts], the examiner will always check to see what was donated to the trust as well as whether or not the present value actuarial amount was properly computed and deducted by the donor.
7. [In any examination of a charitable trust, the examiner should trace the flow of cash] to determine if there are any self-dealing or taxable expenditure issues and to determine if proper payments are made to qualified charities.³⁰²

³⁰¹ See News Release IR-2011-39 (April 7, 2011), available at <http://www.irs.gov/newsroom/article/0,,id=238262,00.html>.

³⁰² IRM § 4.76.5.1.5 (Apr. 1, 2003); see also Rev. Rul. 2006-19, 2006-15 I.R.B. 1 (announcing that the Service “is committed to identifying taxpayers who attempt to avoid their federal tax obligations by taking frivolous positions, based on arguments relating to trusts. The Service will take vigorous enforcement action against frivolous arguments relating to trusts.”).

In *Schulz v. Commissioner*,³⁰³ the Seventh Circuit Court of Appeals stated the government's tolerance level for the repeated attempts to use these schemes for tax avoidance purposes:

Given the deeply rooted instinct not to pay more taxes than the law requires and the endless changes that can be rung in trust draftsmanship, we do not suppose that any single opinion can put a definitive end to devices like the . . . trusts. Nor do we mean to intimidate taxpayers and their attorneys in their search for the equivalent of the better mousetrap. Nonetheless, it should be clear that certain avenues of tax avoidance are closed.³⁰⁴

Other than to know what to avoid, estate planners have no reason to be familiar with these devices. However, the Department of Justice maintains a web site where it has posted descriptions of the most recent scam prosecutions; the cases detailing the failed attempts at using them are fascinating.³⁰⁵ The Service has also issued Publication 2193 for taxpayers describing the more common abusive trust arrangements and announcing the intent to prosecute this type of taxpayer fraud.³⁰⁶

F. Is It a Trust? Is It a Hoax? If Not, What Is It?

With the pace of technology, new concepts in every area of our lives, including trust planning, inevitably will materialize. One concept that has emerged is the idea that a person can be preserved in such a way that he can later be reinvigorated when the technology permits. Will the 529 plan in trust for this person's post-thaw re-education be far behind?³⁰⁷

A small but increasing number of lawyers draft what are known as Personal Revival Trusts (PRT).³⁰⁸ In general, a PRT can be any type of trust that is set up to hold assets for a cryogenically frozen person until he is re-

³⁰³ 686 F.2d 490 (7th Cir. 1982).

³⁰⁴ *Id.* at 497.

³⁰⁵ See U.S. DEPT. OF JUSTICE, TAX DIVISION: SCHEMES/SCAMS, <http://www.justice.gov/tax/injunctions.htm> (last visited Dec. 10, 2011).

³⁰⁶ See I.R.S. Publ'n 2193 (Jul. 19, 2007), available at <http://www.irs.gov/pub/irs-pdf/p2193.pdf>.

³⁰⁷ See Susan T. Bart, *The Best of Both Worlds: Using a Trust to Make Your 529 Savings Accounts Rock*, 34 AM. C. TR. & EST. COUNS. J. 106 (2008).

³⁰⁸ See Igor Levenberg, Comment, *Personal Revival Trusts: If You Can't Take it with You, Can You Come Back to Get It?*, 83 ST. JOHNS L. REV. 1468.

vived.³⁰⁹ These trusts might also have other names—such as simple dynasty trusts, cryonic trusts, or asset preservation trusts—but the concept is the same: A person planning to have his body or consciousness preserved is likely going to need his assets preserved for future use.

On the one hand, to carry out the purpose of these trusts new technology must exist. The issues raised by these trusts are novel and untested, ultimately relying on technological advances in the area of cryonics, many of which are still in the very early stages of development.³¹⁰

On the other hand, traditional trusts and trust doctrines can have novel applications. The beneficiary is typically referred to as a cryonaut—the legally dead trust beneficiary and grantor who has arranged to have his body or head frozen in liquid nitrogen upon death in the anticipation that it will be revived to an animated state when medical technology allows such events to occur. A cryonaut cannot be a trust beneficiary in the traditional sense because they are legally dead.³¹¹

One way to describe the trust beneficiary is as an intermediate being.³¹² Under this theory, the laws applicable to conceived, but unborn, beneficiaries would allow a cryonaut to hold property in trust until his revivification. Under this approach, a grantor could use a purpose trust because no necessarily ascertainable trust beneficiary exists to enforce or benefit from the trust terms.

Another way of describing the beneficiary is as the undead contingent beneficiary.³¹³ This theory is analogous to the unconceived, unascertained beneficiary. Under this theory, the cryonaut is unable to be the sole trust beneficiary, and the PRT's set-up would be analogous to a dynasty trust with revival as a condition subsequent. Until the cryonaut's revival, the trust would distribute funds to the cryonaut's children, grandchildren, and future generations. To preserve the trust principal for its ultimate use for the benefit of the cryonaut, narrowly defining discretionary distributions for beneficiaries other than the cryonaut is advisable. One option would be to use the PRT as an incentive trust to educate multiple generations and

³⁰⁹ *See id.* at 1470.

³¹⁰ *See id.* at 1499.

³¹¹ *See id.* at 1477.

³¹² *See id.*

³¹³ *See id.* at 1489.

perpetuate multigenerational wealth.³¹⁴ Once the cryonaut is thawed, the remaining funds, if any, would revert to him.

Because of the trust's indefinite term, proponents emphasize that establishing the PRT in a jurisdiction without a rule against perpetuities is critical.³¹⁵

The PRT necessarily raises the possibility of legal challenges. The trust agreement must provide the flexibility needed to allow the use of the trust's funds in this situation.³¹⁶ "It is impossible to know what all of the specific contingencies will be, thus we must allow for them when designing the trust and considering the role of the trust protector."³¹⁷ Ultimately, the trust agreement should authorize the trust protector to use funds within the trust to retain whatever assistance is necessary to carry out the trust's purposes.³¹⁸

Those who prepare these trusts advise that a preserved person should consider where he wants to be domiciled and choose a jurisdiction that has repealed the Rule Against Perpetuities.³¹⁹ While the means by which this can be done with any certainty is unclear, they advise that the preserved person choose a jurisdiction where property can be held indefinitely until revival.³²⁰

Similarly, a preserved person may want to establish a trust to maintain property that he would re-inhabit upon revival.³²¹ "Finally, estate taxes are due upon death. A person who plans to undergo cryogenic preservation should ask whether he can assure that he will get these back when he is revived."³²²

Once the revival is complete, the trust theoretically would terminate, or the beneficiary would have the option to terminate it. Again, a trust protector could play a role in this area by determining whether termination is reasonable under the circumstances. Because the timeline of this trust is

³¹⁴ See, e.g., Lauren J. Wolven & G. Scott Clemmons, *Educating Younger Generations Through the Estate Plan*, EST. PLAN., Aug. 2009, at 29, 30.

³¹⁵ See Levenberg, *supra* 308, at 1471-72.

³¹⁶ See *id.*

³¹⁷ John Dedon, *Functions of a Trust Protector During Biostasis and at the Time of Cryogenic Revival*, 1 J. OF PERS. CYBERCONSCIOUSNESS 9 (2006).

³¹⁸ See *id.*

³¹⁹ See Christopher Sega, *Possible Legal Rights of Cryogenically Revived Persons*, 1 J. OF PERS. CYBERCONSCIOUSNESS 12, 12 (2006).

³²⁰ See *id.* at 13.

³²¹ See *id.* at 14.

³²² *Id.*

unknown, naming an institution rather than individual trustee and trust protector is recommended.

For a sample trust instrument under which revival is a condition subsequent, Alcor Life Extension Foundation, one of the major cryogenic freezing companies, has posted its form of irrevocable trust.³²³

VIII. CONCLUSION

Beyond the Crummey trust, the revocable trust, and the alphabet soup of estate planning trusts that include GRATs, CRTs, CLTs, and QPRTs, a number of unusual and lesser known trust arrangements exists. The foregoing discussion is by no means an exhaustive examination of these special use trusts and nontrusts, but it is meant to shed some light on them. Estate planners should be aware of lesser-used trusts that do not fit neatly into the traditional trust model.

³²³ See *Alcor Patient Care Trust*, ALCOR LIFE EXTENSION FOUNDATION, <http://www.alcor.org/library/html/patientcaretrust.htm> (last viewed Mar. 20, 2011).