Title

The constructive general inter vivos power of appointment: A trap for the unwary trustee and his counsel

Summary

The constructive general inter vivos power of appointment is the product of the marriage of power of appointment doctrine and creditors' rights doctrine. It is a topic that is taken up in §4.1.3 of *Loring and Rounds: A Trustee's Handbook* (2013), at pages 263-265. See also §5.3.3.1. The classic definition of a general inter vivos power of appointment (which is tantamount to a power of revocation) is the power to appoint property to oneself *or* one's creditors. Absent a statute to the contrary, it is now generally the case in the U.S. that a settlor cannot place property in trust for the settlor's own benefit and keep it and/or the equitable interest beyond the reach of the settlor's creditors. The maximum amount which *could* be expended by the trustee for the settlor's benefit is vulnerable to creditor attack. Thus, property that is subject to an ostensibly irrevocable fully-discretionary trust (that is discretionary as to both income and principal) for the benefit of the settlor is fully vulnerable to attack by the settlor's creditors. That being the case, the settlor constructively has a power, bestowed by operation of law, to appoint the property to his creditors. The power is exercisable by racking up debts. This power of revocation exists even if the terms of the trust expressly provide otherwise. The landmark case of *Ware v. Gulda*, 331 Mass. 68, 117 N.E.2d 137 (1954), stands for that proposition. The trust restatements are in accord. It was not long after *Ware* came down that the light bulbs went on in the offices of the IRS. The ensuing tax cases are cited in the footnotes to §4.1.3 of the Handbook. The section is reproduced in its entirety below.

§4.1.3 of *Loring and Rounds: A Trustee's Handbook* (2013)

§4.1.3 *Creditor Accessibility as a General Inter Vivos Power of Appointment*

> *Thus the Massachusetts Court…[in Ware v. Gulda]…held that creditors of the settlor-beneficiary could reach the trust assets despite the fact that under the terms of the trust instrument, distributions by the trustee to, or on behalf of, the settlor were completely within its discretion, and even though the interests of the remaindermen beneficiaries would be adversely affected by such action…The* Gulda *decision provided the basis for our holding in Paolozzi v. Commissioner…to the effect that a settlor-beneficiary of a discretionary trust had failed to relinquish dominion and control over such interest for gift tax purposes*.[279]

It is becoming a general rule that a settlor's creditors may reach the trust property to the

[279] Outwin v. Comm'r, 76 T.C.153, 164–165 (1981) (referring to Ware v. Gulda, 331 Mass. 68, 117 N.E.2d 137 (1954) and Paolozzi v. Comm'r, 23 T.C. 182 (1954)).

extent the settlor reserves a beneficial interest.[280] For example, a trust for the benefit of the settlor—fully discretionary as to income and principal—will expose the entire property to creditor attack.[281] The law thus bestows on the settlor the ability to indirectly extract value from the trust by incurring debts and leaving it to the creditors to collect.[282] This right to direct trust property to creditors conforms to the Restatement of Property's definition of a general inter vivos power of appointment.[283] The possession of such a right may have estate and gift tax consequences[284] and may also bear on the settlor's eligibility for Medicaid and on the rights of the settlor's spouse to reach the trust property.[285] Does it also mean, however, that the settlor may terminate the trust other than by incurring debts? Probably not:

> Even if the spendthrift provisions in the trust under consideration are void as to the settlor-beneficiary, this does not mean that the trust is void or that the settlor-beneficiary can terminate the trust without the consent of the other beneficiaries. We think the spendthrift provisions as to the interest of the settlor-beneficiary are severable.[286]

On the other hand, were the settlor the sole beneficiary of the trust, the settlor at any time and notwithstanding the terms of the trust would be able to terminate it and receive back title to the subject property.[287] This would be the case even though the termination would defeat a material trust purpose.[288] There are two qualifications: The settlor must not be under some incapacity at the time of the termination and the terms of the trust must not require that the trustee give consent

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[280]*See* §5.3.3.1 of this handbook (when the settlor's creditors may reach any beneficial interest that have been reserved).

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[282]*See* §5.3.3.1 of this handbook (when the settlor's creditors may reach any beneficial interest that have been reserved). *See, e.g.*, Johnson v. First Nat'l Bank of Jackson, 386 So. 2d 1112, 1115 (Miss. 1980) (deeming a self-settled irrevocable inter vivos trust to be "in effect revocable" because settlor could borrow money up to the value of the trust estate, donate that amount to the Church of Scientology, and then have the creditor levy on the trust estate in satisfaction of the debt). *See generally* §5.3.3.1 of this handbook (whether the settlor's creditors may gain access to beneficial interests that have been reserved).

[283]Restatement (Second) of Property §11.4 (Donative Transfers). *Cf.* 5 Scott & Ascher §34.3 (When Settlor Is Sole Beneficiary) ("When the settlor creates a trust of which the settlor is the sole beneficiary, the settlor can, at any time, terminate the trust, even if doing so would defeat a material trust purpose").

[284]*See* §5.3.3.1 of this handbook (reaching the settlor's reserved beneficial interest).

[285]*See* §§5.3.4 of this handbook (rights of beneficiary's spouse and children to the underlying trust property or to the equitable interest) and 5.3.5 of this handbook (Medicaid eligibility and recoupment). The trustee will find helpful the chart entitled "Trusts Affected by the Omnibus Reconciliation Act of 1993" published in C. B. Kruse, Jr., Third-Party and Self-Created Trusts 19–22 (2d ed. 1998). An earlier version of the chart can be found in Kruse, *Self-Settled Trusts Following OBRA 1993*, 134 Tr. & Est. 66, 68 (Mar. 1995). *See also* Kruse, *OBRA '93 Disability Trusts—A Status Report*, 10 Prob. & Prop. 15 (No. 3) (1996).

[286]Fewell v. Republic Nat'l Bank of Dallas, 513 S.W.2d 596, 598 (Tex. 1974).

[287]*See generally* 5 Scott & Ascher §34.3 (When Settlor Is Sole Beneficiary); §8.2.2.1 of this handbook (trust terminations by consent).

[288]*See generally* 5 Scott & Ascher §34.3. *See also* §8.15.7 of this handbook (the *Claflin* doctrine, also known as the material purpose doctrine).

to the termination.[289]

In 1997, Alaska enacted a statute that may insulate reserved beneficial interests in certain irrevocable, "self-settled," independently trusteed, discretionary trusts (created after April 1, 1997) from the reach of the settlor's creditors.[290] If a settlor of one of these Alaska asset protection trusts has reserved no express right of revocation and if the statute is effective in insulating the reserved beneficial interest from creditor attack, then it could be said that for gift and estate tax purposes the settlor has reserved no general inter vivos power of appointment over the transferred property.[291] Accordingly, although the transfer might have gift tax consequences, down the road the property itself, along with any appreciation, could be out of the settlor's federal gross estate for estate tax purposes.[292] A number of other U.S. jurisdictions have followed Alaska's lead. For more on the domestic asset protection trust, the reader is referred to Section 5.3.3.1 (c) of this handbook.

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[289]*See generally* 5 Scott & Ascher §34.3.

[290]*See generally* §5.3.3.1(c) of this handbook (domestic asset protection havens).

[291]*See* Paolozzi v. Comm'r, 23 T.C. 182, 186 (1954) (gift tax); Outwin v. Comm'r, 76 T.C. 153 n.5 (1981) (estate tax); Paxton v. Comm'r, 86 T.C. 785 (1986) (estate tax).

[292]*See* Paolozzi v. Comm'r, 23 T.C. 182, 186 (1954) (gift tax); Outwin v. Comm'r, 76 T.C. 153 n.5 (1981) (estate tax); Paxton v. Comm'r, 86 T.C. 785 (1986) (estate tax).