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Back Door Slats And Ohio Legacy Trusts: A Solution For Sunset Uncertainty?

As of the writing of this article, the exemption amount is $13,990,000 per person and the temporarily doubled bonus exemptions are scheduled to sunset as of January 1, 2026. If Congress does nothing, the exemptions will be cut in half to slightly more than $7 million per person in 2026 (depending on the inflation adjustment).

It's a "use it or lose it" opportunity (potentially). For example, if a single person with $20 million estate doesn't use the $14 million gift/estate exclusion and then dies in 2026 when the exclusion is reduced by $7 million, the additional tax may be $7 million times 40%, or $2.8 million. Uncertainty looms larger than the ballooning federal debt.

There are two bills pending in Congress to kill the estate and GST tax completely (leaving the gift tax). [1]

Project 2025, the right-wing think tank generating many of the Trump Administration policies, would leave the estate taxes in place but lower the rate to 20%. So far, no bill has yet been introduced to propose that, but it may be an option in any potential compromise.

Clients want flexible options to take advantage of the bonus exclusion yet have a fail safe and back up plan to access the donated assets when needed. This article will summarize and analyze those options. Which are relatively safe? Which are risky? Which are safe on paper, but may be dangerous in practice? Let's introduce what may be the most common trust vehicle used in modern estate tax planning and explore the case law and authority marking the boundaries of its use.

"Back Door" SLATs: Issues When a Settlor Benefits from a SLAT

Spousal lifetime access trusts ("SLATs") have become ubiquitous in estate planning. If successful, assets are removed from the taxpayer's gross estate and the reach of creditors, while providing one or more means for the settlor and their spouse to access the trust while the couple is happily married and the donee spouse is still living.

The stickier issues and controversy occurs, however, when the settlor designs or attempts to access the trust funds through a "back door," even after the death of or divorce from the donee spouse. This is extremely important to "middle wealthy" couples who have enough to worry about future estate tax (especially after December 31, 2025), but not much that they feel they can afford to lose access to multi-million-dollar gifts.

This back-door access may be attempted through receiving income tax reimbursement, loans, compensation for managing trust assets (or a company that is an asset of a trust), or even adding the settlor as a beneficiary or appointee through the exercise of a limited power of appointment or trust protector. Many states have even recently changed their law to be more favorable to the latter, either through laws specific to spouses-only (Arizona, Florida), or more generally in adopting self-settled spendthrift trust legislation (such as the Ohio Legacy Trust Act).

As a general rule, *the greater the settlor's access, the greater the risk of estate inclusion or creditor access*. Either of these can occur even if the settlor is never a beneficiary of the trust. But neither result is inevitable, and some of these avenues of access are relatively safe in many circumstances. It's not as simple as people think.

Trust drafting matters. State law matters. And more so than many techniques and areas of the law, the *actual administration of the trust* is critical. And as part of scrutinizing the trust administration, we cannot forget the management of any closely held family-controlled entities owned by the trust, which is easily overlooked. This article will frame the issues, explain the state debtor/creditor and federal tax law that applies and map the minefields for the practitioner to better avoid and advise their client in this type of planning.

The Lure of SLATs

In some respects, the SLAT is the *Holy Grail* of estate and asset protection planning: the trust assets grow outside of the grantor and grantor's spouse's estates, income tax-free due to the grantor trust status of the trust, all while being more protected from creditors than almost any other vehicle. [2] What's more, while the two spouses get along, the grantor still has indirect access to the assets through the donee-spouse, and can even live in a trust-owned residence as a guest of the beneficiary-spouse without being considered a retained interest! [3]

The SLAT's *Achilles' Heel* and the Temptation of the "Back Door"

All goes well unless and until the parties separate or divorce, or the donee-spouse dies first. Then the grantor-spouse is effectively cut off from the funds, unless the beneficiaries decide to give funds back to the grantor of their own free will, and even that would require a distribution from the trust and an additional taxable gift. For the "ultra-high" net worth, this does not create a problem, but for the mass affluent with barely taxable estates (or those that may become so in 2026), this prospect may prevent them from making any gift in the first place.

In recent years, attorneys have created or discovered several solutions to this issue, what some refer to as a "back-door" to access funds from the trust in the event that the grantor is cut off. This may be through several methods which we will analyze herein, some of which are riskier than others. Most prominent among these is the solution that many states have recently addressed by statute, but we will discuss various lesser recognized solutions including:

- using a domestic asset protection trust (DAPT) statute with the settlor as a current discretionary beneficiary (the *front door*), or permitting a trust protector the ability to add the grantor as a beneficiary (a.k.a. "hybrid-DAPT")
- granting a non-beneficiary a lifetime limited power of appointment permitting distribution of funds to the grantor as a potential appointee
- granting a beneficiary (e.g., spouse, then children) a lifetime limited power of appointment permitting distribution of funds to the grantor as a potential appointee
- granting the spouse a testamentary limited power of appointment permitting distribution of funds to the grantor or to a trust therefore at death
- loans from the trustee to the grantor
- using "floating spouse" provisions that enable distribution to subsequent spouses of the grantor if the current donee-spouse dies or divorces
- granting the trustee the discretionary ability to pay currently due or *reimburse* years of back income taxes already paid on trust income due to grantor trust status, and
- access to wealth through salary/bonuses from trust-owned businesses or fees as investment advisor to the trust.

We will compare and contrast the benefits and risks of the different methods from both an estate inclusion and an asset protection standpoint.

There are two gauntlets that a back door SLAT must run through if it is to still achieve the goal of creditor protection and exclusion from the settlor and settlor's spouse's estates. First, at a minimum it must be protected from general creditors of the

grantor from the outset. Secondly, it must avoid the settlor from retaining or obtaining a retained interest or right of disposition that would trigger estate inclusion.

To set the stage for this discussion, we must first understand the creditor protection ramifications and rules regarding self-settled spendthrift trusts. Even if someone is not concerned about their exposure to creditors, this is still a crucial analysis, because if general creditors of a settlor can access a trust, it is included in the settlor's estate for estate/gift/GST tax purposes. [4]

The *Front Door*: Making the Settlor a Discretionary Beneficiary of a Completed Gift Irrevocable Trust Under the Ohio Legacy Trust Act

Traditionally at common law (and under the Uniform Trust Code), creditors could attach the maximum amount that a trustee could distribute to the settlor, despite a spendthrift clause. This started to change in the United States when Alaska passed the first domestic asset protection trust in 1998. Since then, the trend has gathered steam more and more every year such that as of this writing there are now at least 20 states that permit some form of DAPT. [5]

There is a healthy debate about how effective these will be when established by a resident of a state that does not recognize protection for a settlor as beneficiary of a self-settled spendthrift trust. Indeed, the *Huber* case, involving a Washington state resident establishing an Alaska DAPT, decided that it should not be recognized. [6] Offshore DAPTs have resulted in similar holdings under choice of law principles. [7] If the settlor can relegate trust assets to their creditors by simply incurring debt, those assets should be included in the settlor's estate. [8]

But at least 20 states now, including Ohio and nearby states of Michigan, Indiana, and West Virginia, recognize self-settled "asset protection trusts," and there are no conflict of laws problems if the settlor uses their own state law.

Gifts can be complete to DAPTs (or other hybrid variants like SLATs or hybrid-DAPTs that may later add settlors), provided the assets are not subject to the settlor's general creditors. [9] The open question is when would the IRS find that IRC § 2036 applies-in the PLRs footnoted above, the Service punted on this issue, because it will be based on the facts and circumstances of each case.

In Rev. Rul. 2004-64, the IRS ruled that merely being a discretionary beneficiary does not by itself cause IRC § 2036 to apply and cause estate inclusion (in that ruling, the trustee could pay or reimburse income taxes resulting from grantor trust status, essentially making the settlor a discretionary beneficiary of the irrevocable trust up to a capped amount).

Why not just use a DAPT? Even for those living in a DAPT jurisdiction such as Ohio, there is more risk of the IRS or court finding that the settlor retained an interest in the income of the trust under IRC § 2036. Moreover, there is more chance of voiding a transfer into such a trust under Bankruptcy Code Section 548(e). While being a discretionary beneficiary of a self-settled DAPT **does not, by itself, cause estate inclusion** (more authority for which we will discuss later herein), it is still safer to avoid the potential issue altogether. It would certainly be better to have a DAPT with clean administration and "good facts" (i.e. no settlor control and little to no distributions) than a standard SLAT or IGT with "bad facts" (i.e. settlor control and access), but all things being equal the DAPT is riskier from an estate inclusion perspective.

Thus, clients want more options than the DAPT that seem a bit safer or less complex.

Enter the "hybrid-DAPT" and "back door SLAT."

Adding a Trust Protector who can Add the Settlor as Beneficiary (a.k.a. Hybrid-DAPT): Keeping the *Front Door* Locked Until Needed, and Giving Your Friend a Key

Would the results and uncertainty noted above be different if the settlor were not named a beneficiary initially, but a person acting in a non-fiduciary capacity (such as a trust protector) could add the settlor as a beneficiary?

Isn't this really the same as being a discretionary beneficiary but at the discretion of both the trust protector and the trustee?

There is very little case or statutory law on trust protectors. If the trust protector is not a fiduciary with any duties to the beneficiaries, is there a danger that a court may conclude that the trust protector is merely an agent of the settlor (especially if the protector were also an agent of the settlor in another capacity, such as an accountant or attorney)?

If the trust protector is a fiduciary, how would the trust protector justify adding new beneficiaries to the trust in light of the duties owed to other beneficiaries not to deplete their trust interest?

Adding a Collateral Lifetime Limited Power of Appointment that Includes the Settlor as a Potential Appointee-Special Power of Appointment Trust (SPAT)

A settlor might grant someone who is not a beneficiary a non-fiduciary lifetime limited power of appointment (referred to at common law as a "collateral power"). The power might allow for distributions to the settlor and his or her spouse and descendants, for example (or to another trust therefore). [10]

In contrast to the paucity of law around trust protectors, there are volumes of Restatements of Property that outline hundreds of years of common law, plus a new Uniform Power of Appointment Act with extensive commentary to draw from. [11] There is less chance of a court crafting completely new law in an area such as powers of appointment that is very well-settled.

In theory, the potential appointees may even be limited to only the grantor, but the *optics* of this would not be favorable. Would the result and uncertainty noted above be different if a powerholder could add any descendants of the settlor's maternal grandmother thereby obfuscating the ability to add just the settlor? In some respects, the broader the power, the broader the ability of the powerholder to disappoint the settlor through appointments contrary to the settlor's intent. There is no reason, however, that the power cannot be conditioned upon another's consent to act as an additional safeguard against that.

The exercise of such a power, similar to a trust protector, may lend weight to an argument that there was an implied agreement and/or that the powerholder was merely acting as an agent of the settlor. If such a power is exercised on rare occasion with no apparent influence by the settlor (especially if the power is used to distribute among multiple appointees), this should be viewed more favorably than a power consistently exercised in favor of only the grantor.

Granting a *Beneficiary* a Lifetime Limited Power of Appointment that Includes the Settlor as a Potential Appointee

Granting such a power to a beneficiary rather than to a non-beneficiary has both advantages and disadvantages.

A beneficiary would be adversely affected by the exercise of such a power, so any argument that the beneficiary is a mere agent of the grantor would be much, much weaker-even if the beneficiary is a related party, which would usually be the case. Unlike a non-beneficiary who has nothing whatsoever to lose by naming a grantor as a beneficiary or appointing assets to them, a beneficiary with such power has "skin in the game." Thus, it is probably much safer from an asset protection perspective.

Unfortunately, this same "skin in the game" creates gift tax ramifications to the powerholder. Usually, the exercise of limited, as opposed to general, powers of appointment do not have gift or estate tax effects. There is an exception, however, when a beneficiary reduces their interest in a trust through the exercise of a lifetime appointment. [12] The entire amount transferred would not be a gift, but the amount that their interest is being depleted by is a gift. This valuation may depend on the age of the income beneficiary, the applicable federal rate, distribution terms and other factors. If the amount is minimal, it may even be under the powerholder's gift tax annual exclusion (in 2025, $19,000 per donee, or twice that with spousal consent to gift-split).

Additional Danger in Many UTC States if a Powerholder Can Appoint to Settlor: UTC § 505(a)(2) v. Common Law and Restatement of Trusts

The common law has always had some rule against self-settled trusts (RASST). The Restatement of Trusts, [13] however, focuses only on the power of the trustee, permitting creditors of the settlor to access the maximum amount that can be distributed by a trustee for the settlor's benefit as a *beneficiary*. It does not address amounts distributable by holders of powers of appointment. UTC § 505(a)(2), however, appears to be slightly broader and provides that:

> "(2) With respect to an irrevocable trust, a creditor or assignee of the settlor may reach the maximum amount that can be distributed to or for the settlor's benefit."

Does this includes powers to appoint to the settlor? It is unclear, but thankfully Ohio clarified this in R.C. 5805.06(B)(2) by providing that:

> "(2) None of the following shall be considered an amount that can be distributed to or for the benefit of the settlor:
>
> (a) Trust property that could be, but has not yet been, distributed to or for the benefit of the settlor only as a result of the exercise of a power of appointment held in a nonfiduciary capacity by any person other than the settlor;"

Thus, it's safer to include broad powers of appointment that might include the settlor in an Ohio trust than in most other states.

Granting a *Testamentary* Power of Appointment to Donee Spouse that Includes the Settlor as a Potential Appointee

If the donee spouse dies first, the donee spouse might be granted a testamentary limited power of appointment that permits appointment of a portion to the grantor, or a portion to a new trust that might include the grantor as a discretionary beneficiary.

If the donee spouse simply appoints 10% of the trust back to the settlor (perhaps this much being deemed enough and safe from causing estate tax issues), this may be safe-the remaining portion would presumably have no strings to cause inclusion.

If the spouse appoints to a trust for the grantor, however, we are back to the same self-settled spendthrift trust analysis discussed earlier. The only difference is that some non-DAPT states have recently enacted special statutes that will protect such a trust from being considered a self-settled trust under their state laws. [14]

Example: Husband establishes a SLAT for Wife and their children, but Wife dies first, and she uses her testamentary limited power of appointment to appoint to a new discretionary trust (Trust-2) for Husband and their children (or to her Bypass Trust, which may be similar). Under state law (and federal income tax law), the husband remains the settlor/grantor of the Trust-2. [15] If Wife appoints to a trust a DAPT or that uses the law of one of the states listed in the above endnote, however, it will not be considered a self-settled trust subject to husband's general creditors.

For estate/gift tax law, treasury regulations would prevent this "back door access" from being a § 2036/2038 retained interest if the trust were an intervivos QTIP. [16] This safe harbor, however, would not help non-marital SLATs. We are then left with the general rule similar to if husband had started with a DAPT from the outset—that retaining a discretionary interest may not necessarily be a retained interest, but may be strongly scrutinized for prearrangement or implied agreements, as discussed elsewhere herein. The optics and analysis for this situation, however, may be much more favorable to the settlor, however, since the settlor arguably did not "retain" the interest if he did not have that until his wife's death and his wife at all times had unfettered ability to exercise her testamentary power.

Granting the Trustee the Ability to Loan Funds to Grantor, Swap or Purchase Assets from the Grantor

The settlor might be able to receive a loan under general or specific loan powers granted to the trustee. If done correctly, this might be much safer, and, unlike receiving distributions, has the potential to be much more transfer tax efficient. Distributions add to the grantor's estate but loans would not (provided that the loan is bona fide and allowed as a deduction to the estate under IRC § 2053). After all, the popular technique of an installment sale to an irrevocable grantor trust is essentially a loan between the parties (albeit in the opposite direction).

A provision may even be added to the trust instrument to permit a person acting in a non-fiduciary capacity to loan the settlor trust funds without adequate security. Such a provision would be another beneficial trigger to cause the trust to be a grantor trust, but also provides some indirect access. [17]

The issue with any loans between family members and trusts, however, is whether they are truly handled as bona fide loans? Is there a written instrument signed by the borrower with arm's length terms? Is there a payment of interest? Do the parties involved record the transaction as a loan and treat it as such (including on personal financial statements filed with lenders)? It's not uncommon for clients to fail to handle intra-family loan transactions properly. Failing to handle loans properly may be proffered as evidence of a retained interest or implied agreement.

If it's merely a cash flow issue and the grantor is temporarily "cash poor," it may be safer for the trustee to *buy* the grantor's property instead. Modern irrevocable grantor trusts often have a "swap" or power to substitute property of equivalent value, and this might be done even if there is not such a clause in the trust, as long as it's fair to the trust to do so. Transactions between the grantor and an irrevocable grantor trust as to the grantor would not be taxable events. [18]

What does the settlor want to do with the funds? If it's to buy vacation home and artwork for it, perhaps the trust can buy the property and allow the donee-spouse to live in it. There is binding authority that if the spouse has the right to use property owned by the trust simply shares time and allows the settlor to use it as well, that this does not cause IRC 2036 to apply. [19]

Reasonable bona fide loans should not cause estate inclusion, but loaning most of the corpus back when the grantor later has financial problems may not be reasonable or prudent. Arms-length is key and conservative is better. Who knows where each IRS agent or tax court judge will draw the line?

Using "Floating Spouse" Provisions

A "floating spouse" provision is one where the "grantor's spouse" is the beneficiary of the SLAT, but this term is defined as whomever the settlor is married to at any given time. If the grantor and spouse divorce, the spouse is removed as a beneficiary. If the grantor ever remarries after divorce or death of the donee spouse, the new spouse of the settlor is now a current beneficiary. There are some advantages, but also serious considerations and problems with the "floating spouse" technique.

While such a provision is not permitted in a marital deduction trust (QTIP), it may be permitted in a SLAT. Such a clause does not by itself cause estate inclusion of a SLAT. Just because it is permitted, however, does not mean that it should always be used. It may easily backfire on the settlor (and/or the settlor's attorney).

Example: Husband gives $10 million to SLAT for Wife and they later file for a divorce. They have $20 million in non-trust property that is marital. If the SLAT had stayed intact, the divorce court might consider the W's equitable ownership interest in the SLAT as part of her 50% share of total assets and award only $5 million of the marital assets to her, leaving husband with $15 million. Alternatively, the state may consider the donee spouse's access to the SLAT as negating the need for further alimony/support, depending on how the court looks at the issue. If the Wife is removed altogether, however, the domestic relations court may be compelled to award the donee spouse much more-perhaps the full $10 million (half of the marital assets) ***plus*** alimony, child support or other equitable adjustments, leaving husband with much less than he would otherwise have had, and potentially provide a premature windfall to the children.

The clever "floating spouse" provision could cost the husband more in a divorce settlement and division of assets than if it had not existed. Would a typical domestic relations judge really just sit in awe about how clever it is, *especially* if marital assets were used to fund the trust? Might it be better if a trust protector could modify the spouse's interest in the SLAT pursuant to any domestic relations court order so that that interest can be considered as part of that spouse's share of assets in a property division? These are very messy issues that may vary by court, judge and county as well as by state. [20]

"Floating spouse" provisions may also kill state statutory back-door SLAT protections in some states. [21]

And don't forget the potential conflict and ethical issues if the law firm represents (or formerly represented) the disinherited spouse. There is a currently a large malpractice and fraud action pending against a law firm where a divorcing spouse is arguing that the law firm breached its ethical obligation to her as a joint client where her husband's SLAT for her benefit (with a floating spouse provision) was decanted to Wyoming for "divorce protection" while they allegedly represented her as well. [22]

While it may be safe, and possible, to provide for a future spouse as a beneficiary (even safer if widowed than in the divorce context), if you think you can just decant and redefine "spouse" so as to add a new spouse to a SLAT later—think again! One attorney tried to do that for their client and ended up getting a $3.225 million judgment against him! [23]

"Turbo" Tax Reimbursement—Granting the trustee the discretionary ability to reimburse years of back income taxes paid on trust income due to grantor trust status

Rev. Rul. 2004-64 permits a settlor to be reimbursed by the trustee, in the trustee's discretion, for income taxes paid on trust income, without ill tax effects. But there are limits to that protection—the IRS will consider other factors, such as whether there was a preunderstanding with the trustee to reimburse or whether state law makes a portion of the trust accessible to a settlor's creditors under the common law rule against self-settled trusts.

If that power is exercised regularly, it may create the optics of an implied agreement with the trustee. If the tax reimbursement is not supported by an analysis and confirmation of the grantor's tax returns of the tax amount eligible to be reimbursed, will it be respected?

At least five states have now amended their statutes to expressly permit reimbursing a settlor for their grantor trust income tax burden, even if the trust document does not permit. [24] Ohio is considering a similar statute.

What happens when the grantor 25 years later wants 25 years' worth of state and federal income tax reimbursements (what we might call a "turbo-tax" reimbursement)? No state law and very few trust reimbursement clauses have any time period or cut-off date. Rev. Rul. 2004-64 does not mention any cut-off date either. In a state like Ohio that provides protection for such payments, this may be a safe avenue for access.

Access to Wealth Through Trust-Owned Businesses

If the settlor works in a business owned in part by the trust, the settlor may be able to access funds through that. Often entrepreneurs and business owners are legitimately underpaid and the business could easily justify higher salaries or bonuses. This can only go so far, of course, and would be taxable income also subject to employment taxes. Just as in other areas of income tax law where an owner's compensation may be scrutinized and recharacterized as too high (common for a C corp) or too low (common for an S corp), it is best to research and keep within the range of a reasonable salary for comparative positions.

One minor advantage to this is that for payments made in the ordinary course of business as salary/bonus, the entity reporting this properly as a deduction and the employee reporting it as income should start the gift tax statute of limitations on the transaction regardless of whether it was reported on a Form 709.

A settlor could also receive a fee to act as the trust's investment trustee/advisor in a directed trust, but this would be far down on my list of the best ways to legitimately access wealth from the trust. Would this be taxable income if coming from a grantor trust?

Caution—Ways to Blow Up a SLAT in Administration

In the McCabe's Estate v. U. S., 201 Ct. Cl. 243 (1973), husband established an irrevocable trust with a longtime friend and business associate as trustee. It provided for income plus principal distributions for illness or emergency to his wife, remainder to their children. Twenty years later, the wife sent the trustee letters requesting distributions be made to her husband (the grantor). The trustee made four payments to him before his death. The court found there to be a retained interest under IRC § 2036 even though the husband was never added as a beneficiary by a trust protector and was never appointed assets by a holder of a lifetime power of appointment. Sloppy administration can cause estate inclusion (or creditor access) no matter how perfect the trust is drafted and how protective state law may be.

Consider other common trust administration situations that may also cause risk. If the parties mae a contribution to the SLAT from a joint account or from community property, is 50% of this gift causing estate inclusion risk because it came from the donee spouse? If the donee spouse deposits a SLAT distribution into a joint checking account and the donor-spouse pays personal bills from that account, is that still a permissible indirect benefit or closer to the *McCabe* case? How many clients with SLATs keep separate accounts to avoid both contribution and distribution issues?

Some clients are charitably minded. Usually, it would be optimal to make contributions from a source other than a SLAT, but if the SLAT does make such distributions, be careful they are not to satisfy a binding pledge of the donor spouse.

As we know from the *Estate of Grace*, spouses should avoid the reciprocal trust doctrine that might place the spouses in the same economic position as if they had put the funds in trust for themselves. Using a DAPT trust may provide an additional back up for such an argument, since it may be possible to do that from the outset in a DAPT anyway!

Same day immediate transfers from beneficiary-spouse to grantor-spouse (including transfers immediately after transmutation) and then to the SLAT risk being considered together as one transaction—i.e., a transfer from the beneficiary-spouse to their own SLAT, likely triggering § 2036. How much time between transfers is needed? See the *Smaldino v. Comm'r of Internal Revenue*,[25] and further back, *Betty R. Brown v. U.S.*[26]

Advisors should also beware of too much donor control and loose personal spending from LLC/LP/corporate entities owned by the SLAT. In *Estate of Reichardt v. C.I.R.*,[27] the settlor transferred FLP interests but retained control of partnership checking account and used it for personal expenses and lived in a home owned by the FLP rent-free. The tax court held that it was included in his estate.

Whether a creditor may access a trust or the IRS finds there to be estate inclusion is never just a technical analysis of the law or trust instrument but very much fact dependent on surrounding circumstances and how the particular trust plan is administered. Excessive foot faults in forming, funding or administering any trust plan could undermine the intended results no matter how secure the practitioner believes the law may be. Consider the *Smaldino v. Comm'r of Internal Revenue*[28] and *Sorensen v. Comm.*[29]

Where is the sweet spot and how can we convey the risks of all these potential methods of access to clients? There is no simple answer and there are often a myriad of personal considerations and client idiosyncrasies that influence planning decisions. Examples: “I want it simple,” said every client ever, with even the most complex estates.

Reality check—you can never identify the exact sweet spot and practitioners should caution clients of that reality. There is never an optimal plan that can be achieved, and certainly one can never even know what “optimal” was except with hindsight.

IRC § 2036 Case Law Emphasizing Trustee Independence and Scrutinizing the Administration for Implied Agreements

Inclusion under IRC § 2036 is always a factual issue, whether a trust is a DAPT, a SLAT or some other vehicle.

IRC 2036(a) provides that:

> The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money’s worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—(1) **the possession or enjoyment of**, **or** the right to the income from, the property, or

Private Letter Ruling 8037116 is an early Private Letter Ruling (PLR) where the IRS held that a self-settled trust was not in the settlor's estate on account of state law.

Estate of German v. U.S.,[30] held there was no estate tax inclusion in the estate of settlor who was eligible to receive income and corpus from the trust because her creditors could not attach the trust property under the law under which the trust was created.

PLR 200944002 ruled that the IRS will look to facts of administration during settlor's lifetime and a settlor holding a discretionary interest does not trigger inclusion *per se*. PLRs are not citable authority, however.

Here are some cases on whether a settlor's discretionary interest causes inclusion (whether creditors could attach was either not at issue or did not apply). Most involve IRS victories on bad facts, but not all:

- In re Uhl's Estate, 57-1 U.S. Tax Cas. (CCH) P 11677, 50 A.F.T.R. (P-H) P 1746 (7th Cir. 1957)—Settlor'received $100/month and could receive more in discretion of trustee. The court found that the amount necessary to produce $100/month of income was included in his estate, but the rest of the trust was **not** included in his estate, even though the trustee had wide discretion to distribute more (and did). The trustee exercised his discretion in favor of the settlor in only two out of the eight years of the Trust's duration, and during these two years the discretionary payments were irregular and were never paid directly to the settlor, but indirectly, for medical expenses.
- McNichol's Estate v. C.I.R., 59-1 U.S. Tax Cas. (CCH) P 11868, 3 A.F.T.R.2d 1838 (3d Cir. 1959)—Donor/Father gave away properties in fee simple to children but had oral agreement with them to receive the rental income and actually did receive it prior to death. Even if not binding, the court held the donor retained enjoyment of the property and it was included in the donor's estate.
- Skinner's Estate v. U.S., 63-1 U.S. Tax Cas. (CCH) P 12140, 11 A.F.T.R.2d 1855 (3d Cir. 1963)—Settlol had discretionary interest in trust (no right to income), but actually received the income annually for 17 years (in fact, she had tried to initially deduct the value of the life estate from the value of the gift, but lost). The Court found that a prearrangement could be **inferred** from the evidence. The Court distinguished *Uhl* on its facts, and held that the trust was fully included in the settlor's estate: "We point out, however, that every case of this sort must stand on its own facts and that the practice of assuming that a trustee, corporate or otherwise, is necessarily independent of the cestui whom he represents, need not be followed invariably but may be rebutted by circumstances." Similar is *Estate of Green v. Commissioner of Internal Revenue.* [31] As the *McCabe* case illustrated, the focus of the question may not be on whether the settlor is even a *de jure* beneficiary, but whether they *de facto* receive the equivalent of the income (or possession or enjoyment) of the trust.

If there is no absolute right, an important focus will be on whether the trustee is truly independent, as was emphasized in *Skinner's Estate*—in *McCabe*, the trustee was a friend of the settlor. Consider this concern of the district court decision that was upheld in Skinner: "Most settlors would have no trouble finding a trustee friendly to his interests who could be counted on to honor informal prearrangements to exercise "absolute discretion" over income payments in favor of the settlor during his life. The existence of such prearrangements is difficult at best for the government to prove. Therefore, the court must go beyond the form in which the agreement is drawn, and, looking to the substance of the matter, draw reasonable inferences from the evidence that such a prearrangement did exist." A corporate trustee is the gold standard. What if the trustee is also an agent of the settlor, such as the settlor's attorney? Would this trigger questions as to independence, such as in the *Diller v. Richardson* litigation?

Similarly, the tax court in *Estate of Paxton v. C.I.R.*, stated:

> "Indeed, the existence of an agreement or understanding by which the possession or enjoyment of the property is retained may be inferred from the circumstances of the transfer and the manner in which the transferred property is used." [32]

Conclusion

Take precautions. Adding any back-door access, whether through a trust protector or a lifetime limited power of appointment, adds some risk of creditor access.

Potential creditor access may result in estate inclusion, but even if state law is protective (and Ohio's is), IRC § 2036 can pull in a trust where settlor retains *de facto* "enjoyment and possession."

Take steps to make SLAT and DAPT plans of all types safer:

- Start with financial modeling and planning (or have client's financial team do so) to demonstrate that there is no likely need to rely on SLAT assets post-transfer (e.g., see the Reichard case where donor had gifted away nearly everything and tax court found this suggested implied agreement with donees)
- Using independent trustees also helps avoid prearrangement arguments (and sloppy administration) under IRC § 2036 (e.g., McCabe case), even if they can be removed and replaced
- Use a DAPT jurisdiction (like the Ohio Legacy Trust), or at least one with strong back door interest protection and clear protection for grantor trust income tax reimbursement
- Have annual review meetings to monitor SLAT administration, especially that any loan and interest payments are being made timely (include review for sloppy administration of closely-held entities owned by SLAT, especially those managed by settlor)
- Have both time and independent economic events intervene if assets are retitled as between spouses and report those transfers on gift tax returns
- Don't allow the settlor to unilaterally make state PTE elections for trust-owned pass through entities that in effect allow the settlor to have their state income tax bill on trust/PTE income indirectly paid by the trust
- Warn clients in writing that each of these (and other) incremental access points adds additional risk but that none of those risks can be quantified. Be careful, but not paranoid. Let the client take the risk if they're fully informed, but don't be their insurance by overpromising a particular result.

Footnotes

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1 E.g., Death Tax Repeal Act, H.R.1, 119th Cong. 2025.

2 If the SLAT has a truly independent trustee, this should give even greater certainty as to protection, since many of the cases that "pierce" third party created irrevocable trusts involve improper and collusive administration. See, generally, *Asset Protection Dangers When a Beneficiary Is Sole Trustee and Piercing the Third Party, Beneficiary-Controlled, Irrevocable Trust*, LISI Asset Protection Planning Newsletter #339 (March 9, 2017), available at https://www.naepc.org/events/newsletter/3/2017.

3 Rev. Rul. 70-155, citing Estate of Gutchess v. C. I. R., 46 T.C. 554, 1966 WL 1184 (T.C. 1966), acq., 1967-2 C.B. 1.

4 Vander Weele v. C.I.R., 27 T.C. 340, 1956 WL 577 (T.C. 1956), nonacq., 1957-2 C.B. 3 and aff'd, 58-1 U.S. Tax Cas. (CCH) P 11760, 1 A.F.T.R.2d 2138 (6th Cir. 1958) and nonacq. withdrawn, acq., 1962-2 C.B. 3, 1962 WL 70827 (1962); Rev. Rul. 76-103.

5 Thirteenth ACTEC Comparison of the Domestic Asset Protection Trust Statutes, Updated through August 2022, Edited by David G. Shaftel, available at https://shaftellaw.com.

6 In re Huber, 493 B.R. 798, 2013 WL 215421 (Bankr. W.D. Wash. 2013) (Order Granting Trustee Partial Summary Judgment, May 17, 2013).

7 In re Brooks, 32 Bankr. Ct. Dec. (CRR) 23, 1998 WL 35018 (Bankr. D. Conn. 1998) (holding that spendthrift provisions set forth in Jersey (Channel Islands) and Bermuda trusts funded with property

transferred by a U.S. debtor-beneficiary, were unenforceable under Connecticut law, which the court found to be applicable notwithstanding contrary choice of law provisions in the governing instruments); In re Portnoy, 201 B.R. 685, 702, 1996 WL 600839 (Bankr. S.D. N.Y. 1996) (similar result and reasoning).

8 Rev. Rul. 76-103

9 See Priv. Ltr. Rul. 9837007 (1998) and Priv. Ltr. Rul. 200944002 (2009).

10 See Jonathan Blattmachr, Mitchell Gans and Abagail O'Connor on *SPATs—Special Power of Appointment Trust, A Flexible Alternative to Domestic Asset Protection Trusts (DAPTs),* available at https://interactivelegal.com/spats-a-flexible-asset-protection-alternative-to-dapts.

11 The Uniform Power of Appointment Act (Unif. Powers Appoint. Act §§ 101 et seq.), available at www.uniformlaws.org, has been passed in twelve states as of May 2023 and has been introduced in Washington, DC.

12 Rev. Rul. 79-327; Estate of Regester v. C.I.R., 83 T.C. 1, 1984 WL 15589 (1984); though contrary is Self v. U.S., 135 Ct. Cl. 371 (1956). The IRS, in TAM 9419007 (1994), has indicated it will follow *Estate of Regester* (finding a gift by the beneficiary-powerholder) and not Self v. U.S.

13 Restatement Third, Trusts § 58(2); Restatement Second, Trusts § 156.

14 Ariz. Rev. Stat. Ann. § 14-10505(E); Del. Code Ann. tit. 12, § 3536(c)(2); Fla. Stat. Ann. § 736.0505(3); Ky. Rev. Stat. Ann. § 381.180(8)(a); Miss. Code Ann. § 91-8(c)4; N.C. Gen. Stat. Ann. § 36C-5-505(c); Tenn. Code Ann. § 35-15-505(d); Tex. Prop. Code Ann. § 112.035(g); Wis. Stat. Ann. § 701.0505(2)(e).

15 Treas. Reg. § 1.671-2(e)

16 Treas. Reg. § 25.2523-1.

17 IRC § 675(2).

18 Rev. Rul. 85-13.

19 Estate of Gutchess v. C. I. R., 46 T.C. 554, 1966 WL 1184 (T.C. 1966), acq., 1967-2 C.B.1.

20 See Baker and Morrow, Special Considerations For Spousal Lifetime Access Trusts, 32 No. 2 Ohio Prob. L.J. NL 11 (November/December 2021) (discussing Kim v. Kim, 2020-Ohio-22, 150 N.E.3d 1229 (Ohio Ct. App. 9th Dist. Summit County 2020).

21 E.g., Fla. Stat. Ann. § 736.0505(3)(a)3.a.

22 https://www.forbes.com/sites/hanktucker/2023/11/01/hedge-fund-billionaire-john-overdecks-estranged-wife-sues-over-movement-of-trust-assets-to-wyoming-before-her-divorce-filing.

23 See New Hampshire case of *Wright v. McDonald*, 317-2020-EQ-00202, assessing $3.225 million in damages against a trustee for trying to do so. https://www.probatetrial.com/wp-content/uploads/2025/02/Wright-v.-McDonald-Order-January-24-2025.pdf.

24 Colo. Rev. Stat. Ann. § 15-5-818; Del. Code Ann. tit. 12, § 3344; Fla. Stat. Ann. § 736.08145; N.H. Rev. Stat. Ann. § 564-B:8-816; N.Y. EPTL § 7-1.11.

25 *Smaldino v. Commissioner of Internal Revenue,* T.C. Memo. 2021-127, T.C.M. (RIA) P 2021-127, 122 T.C.M. (CCH) 298 (2021).

26 Brown v. U.S., 2003-1 U.S. Tax Cas. (CCH) P 60462, 91 A.F.T.R.2d 2003-2085, 2003 WL 1989618 (9th Cir. 2003).

27 Estate of Reichardt v. C.I.R., 114 T.C. 144, 2000 WL 230358 (2000).

28 *Smaldino v. Commissioner of Internal Revenue,* T.C. Memo. 2021-127, T.C.M. (RIA) P 2021-127, 122 T.C.M. (CCH) 298 (2021).

29 Sorensen v. Commissioner of Internal Revenue, 2021 WL 12347210 (T.C. 2021).

30 Estate of German'v. U.S., 7 Cl. Ct. 641 (1985).

31 Estate of Green v. Commissioner of Internal Revenue, 64 T.C. 1049, 1975 WL 3012 (1975), acquiescence in result only recommended, AOD-1976-437, 1976 WL 39631 (I.R.S. AOD 1976) and acq., 1976-2 C.B.1.

32 Estate of Paxton v. C.I.R., 86 T.C. 785, 810, Tax Ct. Rep. (CCH) 43021, 1986 WL 22122 (1986).

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