# THE ALASKA DYNASTY TRUST

# STEPHEN E. GREER\*

This Article aims to illustrate the unique benefits of utilizing a dynasty trust in Alaska. The fundamental dynamics of a dynasty trust are explained, as well as the advantages of locating such a trust in Alaska. Alaska has the advantage of avoiding the Delaware Tax Trap and provides superior creditor protection to beneficiaries. Four different drafting techniques designed to achieve creditor protection are suggested and discussed. Finally, some observations about drafting in light of the Economic Growth and Tax Relief Reconciliation Act of 2001 are highlighted.

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<sup>\*</sup> Sole practitioner; LL.M., University of Miami, Florida, 1985; J.D., University of Arizona, 1978.

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#### I. Introduction

The purpose of this Article is to familiarize the unacquainted with dynasty trusts and the unique advantages that Alaska has over other dynasty jurisdictions. The Alaskan advantages, which allow taxpayers to avoid the Delaware Tax Trap and afford greater creditor protection to beneficiaries, are discussed in detail. The passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") has made dynasty trusts a centerpiece of estate planning. Dynasty trusts have come to the forefront because many estate planning practitioners feel estate and generation-skipping taxes will not be repealed, or if repeal does occur, these taxes will once again reappear. If assets can be transferred tax-free to a dynasty trust prior to the re-enactment of new estate tax legislation, then these assets might escape any future estate and generation-skipping tax.<sup>2</sup> The focus of this Article is an Alaskan third-

<sup>1.</sup> Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 70 (2001).

<sup>2.</sup> This assumes any future estate and generation-skipping tax would not be retroactively imposed. If a retroactive tax was imposed, it would be difficult to challenge as the courts have repeatedly upheld retroactive tax legislation against

party settled trust, where an Alaskan settlor establishes a trust (most typically at death, but it can also be established during life) for the benefit of individuals other than himself. The Alaskan self-settled trust, where the settlor is retained as a discretionary beneficiary, will not be discussed.<sup>3</sup>

A dynasty trust is an irrevocable trust intended to benefit successive generations of beneficiaries. The settlor of a dynasty trust usually has two objectives. The first objective is to protect the assets for the longest possible period of time from the eroding effect of federal transfer taxes while making the assets available for future generations. These transfer taxes are the federal gift tax, the estate tax and the generation-skipping tax. The second objective is to protect the trust assets from claims that may be brought by a beneficiary's creditors. To accomplish both objectives, the assets must be permitted to continue in trust.

Under the Rule Against Perpetuities, beneficial interests must at some point vest and the trust assets be distributed to the beneficiaries. Once the assets are distributed to the beneficiaries, both transfer tax and creditor protection are lost. As a result, dynasty trusts work best in states, such as Alaska, that have either abolished or extended the Rule Against Perpetuities. Other states that have eliminated the Rule include Arizona, Colorado, Delaware, Idaho, Illinois, Maine, Maryland, Missouri, New Jersey, Ohio, Rhode Island, South Dakota, Wisconsin, and Virginia. Florida ex-

due process challenges. For example, a provision in 26 U.S.C. § 2057, enacted in December 1987, but retroactive to October 1986, which set forth qualifications for the deduction of the sale of employer securities by the executor of an estate to an employee stock-ownership plan was upheld. United States v. Carlton, 512 U.S. 26 (1994). In addition, a retroactive increase in the estate and gift tax rates under the Omnibus Budget Reconciliation Act of 1993 was upheld where there was a retroactive restoration of the maximum estate and gift tax rates of 55% and 53%, although the maximum rates had been reduced to 50% approximately seven months earlier. Quarty v. United States, 170 F.3d 961 (9th Cir. 1999); NationsBank v. United States, 44 Fed. Cl. 661, 666 (1999).

- 3. The self-settled trust permitted under Alaska law has been the subject of extensive commentary. See, e.g., R. Hompesch II, Domestic Asset Protection Trusts: More Might Than First Appears, 1 Asset Protection Journal, #2 at 19; G. Rothschild, D. Rubin, & J. Blattmachr, Self-Settled Spendthrift Trusts: Should a Few Bad Apples Spoil the Bunch?, 32 VAND. J. TRANSNAT'L L. 763 (1999).
- 4. ARIZ. REV. STAT. § 14-2901 (2000); COLO. REV. STAT. § 10-15-120 (2000); DEL. CODE ANN. tit. 25, § 503 (2000); IDAHO CODE § 55-111 (Michie 2000); 765 ILL. COMP. STAT. 305/4 (2001); ME. REV. STAT. ANN. tit. 33, §101-A (West 2000); MD. CODE ANN., EST. & TRUSTS §11-102 (2000); Act of May 18, 2001, sec. A 2001 Mo. Legis. Serv. 3, 563 (West) (to be codified at Mo. REV. STAT. § 456.236); N.J. STAT. ANN. § 46:2F-9 (West 2001); OHIO REV. CODE ANN. § 2131.09 (Anderson

tended the "wait and see" period set forth in its version of the Uniform Statutory Rule Against Perpetuities ("USRAP") from 90 years to 360 years,<sup>5</sup> and Washington extended this period to 150 years.<sup>6</sup>

On April 2, 1997, Alaska effectively eliminated its Rule Against Perpetuities with regard to beneficial interests held in trust, but only where all or part of the income or principal of the trust could be distributed at the trustee's discretion to a person who was living when the trust was created. Thus, the door opened for Alaska dynasty trusts. As will be discussed, Alaska's Rule Against Perpetuities statute was amended in 2000 and again in 2001. Nonetheless, it can still be said that Alaska has abolished the Rule except in a very limited circumstance where it has been extended to 1000 years. Because dynasty trusts provide enormous advantages for the beneficiaries, repeal legislation of this type is a growing trend. In the meantime, states that have not enacted similar dynasty trust legislation face the threat of having their capital base eroded as individuals move their assets into jurisdictions such as Alaska that permit dynasty trusts.

#### II. ACCOMPLISHING THE TAX OBJECTIVE

The diminishing effect of the federal transfer tax can be demonstrated by a simple illustration. Assume \$1 million is placed in trust and the assets grow at an annual after-tax return of 5%. Assume further that this amount is distributed outright, and that every thirty years the assets are passed on to a succeeding generation but are subject to an estate tax rate of 50%. After 120 years, \$1 million would grow to \$21,806,999. However, if \$1 million were held in a trust, without the beneficiaries having sufficient rights of

<sup>2001);</sup> R.I. GEN. LAWS § 34-11-38 (2000); S.D. CODIFIED LAWS § 43-6-3 (Michie 2001); WIS. STAT. § 700.16 (2000); VA. CODE ANN. § 55-13.3 (Michie 2001).

<sup>5.</sup> FLA. STAT. ch. 737.4032 (2000).

<sup>6.</sup> Wash. Rev. Code § 11.98.130 (2001).

<sup>7.</sup> ALASKA STAT. § 34.27.050(a)(3) (Michie 1997).

<sup>8.</sup> It should be noted that section 511(c) of EGTRRA reduces the top estate tax rate from 55% to 50% in the year 2002, and this rate is thereafter reduced by one percentage point each succeeding year. In the year 2007, the top rate will be 45%, and it will stay at this rate until 2010 at which point the estate tax will be repealed. The estate tax will be resurrected in 2011, and the highest rate will once again be 55%. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 511(a)-(c), 115 Stat. 70 (2001).

ownership to warrant inclusion of the trust assets in their estate tax base, this amount would grow to \$348,911,561.9

# A. Intervivos and Testamentary Dynasty Trusts

Dynasty trusts can be created during a settlor's life or at his death. A trust created during life is established as an irrevocable trust. The transfer of the settlor's assets to the trust constitutes a gift to the beneficiaries of the trust. The most an individual settlor can contribute to the trust without the imposition of gift tax is an amount equal to the settlor's unused applicable exclusion amount.<sup>10</sup> In 2001, this amount is \$675,000; however, as a result of EGTRRA, this amount increases to \$1 million in 2002 and remains constant in the future. Under the gift and estate tax regime in place prior to the enactment of EGTRRA, the applicable exclusion amount was unified. If an individual's applicable exclusion amount is eliminated through lifetime gifts, an estate tax would have to be paid at death if the recipient is not a public charity or a U.S. citizen spouse. EGTRRA changes the unified structure of the gift and estate tax regimes by exacting a gift tax on any lifetime gifts in excess of \$1 million, despite the fact that the estate tax might be eliminated. Retaining the gift tax protects the income tax regime by preventing wealthy individuals from transferring assets to individuals whose income tax rate is lower than their own.

Because one purpose of a dynasty trust is to have the assets available for the use of future generations, it is essential that the trust be exempted from the imposition of the generation-skipping transfer ("GST") tax. In 2001, a flat generation-skipping tax of 55% is imposed on distributions of trust property that benefits individuals two or more generations removed from the settlor ("skip beneficiaries"). The 55% rate is scheduled to decrease, but it will always be equal to the highest estate tax rate during the years 2002 through 2009. Because a dynasty trust by its nature is meant to benefit individuals two or more generations removed from the settlor, the possibility exists that a GST tax will be imposed, either immediately when the trust is formed if all beneficiaries are skip individuals, or later when the trust assets are distributed to a skip beneficiary. The only way to avoid the GST tax is for the trust to be exempt from it. Each individual has the ability to exempt a certain amount from this tax. The GST exemption in 2001 is \$1,060,000,11 and that amount is increased for inflation in 2002 and

<sup>9.</sup> R. Oshins & J. Blattmachr, *The Megatrust: An Ideal Family Wealth Preservation Tool*, Trusts and Estates 20, 22 (1991).

<sup>10.</sup> I.R.C. § 2505(a)(1) (2001).

<sup>11.</sup> *Id.* § 2631(c).

2003. In 2004 and subsequent years, the GST exemption will equal the amount that can be transferred estate tax-free. The GST exemption will disappear when the GST tax is repealed in 2010, then will revert back to \$1,060,000 with a cost of living adjustment in 2011 when the GST tax is restored. To avoid the GST tax, the settlor must allocate GST exemption in an amount equal to the value of the assets contributed to the trust. The settlor will allocate this exemption on a gift tax return filed for the year in which the gift was made. Assuming GST exemption was allocated to the trust in an amount equal to the fair market value of the assets contributed to the trust, the trust assets will be exempt forever from the GST tax when the assets are distributed to skip beneficiaries.

It is doubtful many individuals will want to make intervivos gifts to a dynasty trust if they have to pay a gift tax, particularly if the assets can be transferred at death free of estate and GST taxes. It is more likely the settlor of an intervivos dynasty trust will instead want to leverage the amount that can be gifted free of the gift tax. Assume the settlor wants to establish an intervivos dynasty trust in 2002. The most that can be transferred free of the gift tax is \$1 million. Instead of transferring \$1 million directly to the trust, the settlor could first contribute assets worth \$1 million to a limited liability company ("LLC") and thereafter gift his LLC interests to the trust. The amount of the gift would be the fair market value of the LLC interest, and not the underlying pro-rata value of the assets held in the LLC. The fair market value of the LLC interest being gifted should be discounted to reflect its lack of marketability and any lack of control that can be attributed to the gifted interest.14

To preserve the trust estate from the imposition of state income tax, the trust should be sitused in a state that does not impose state income taxes, or alternatively the assets should be invested in a manner where income tax liability is reduced. In this regard, Alaska provides an additional advantage to the settlors of dynasty trusts in that there is no state income tax. Furthermore, if a trust is considered a grantor trust under the rules set out in sections 671-679 of the I.R.C., the federal income taxes on the income earned by the trust will be taxed to the settlor at the settlor's rates and not by the trust at the onerous income tax rates of trusts. The payment of the income taxes by the settlor not only preserves the corpus of the

<sup>12.</sup> Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 521(c)(2), 115 Stat. 70 (2001).

<sup>13.</sup> Id. § 901.

<sup>14.</sup> See Estate of Bright v. United States, 658 F.2d 999, 1006 (5th Cir. 1981); Rev. Rul. 93-12, 1993-1 C.B. 202-03.

trust, but also the payment of the taxes is not considered an additional gift by the settlor to the trust. 15

Because many individuals are hesitant to make lifetime gifts, dynasty trusts are often funded at death. Presently, the estate tax applicable exclusion amount is \$675,000. Under EGTRRA the applicable exclusion amount is scheduled to increase as follows: \$1 million in 2002 and 2003, \$1.5 million in 2004 and 2005, \$2 million in 2006, 2007 and 2008, \$3.5 million in 2009, with no estate tax in 2010 and then back to \$1 million in 2011. As previously mentioned, the GST exemption commencing in 2004 tracks the estate tax applicable exclusion amount. If the decedent dies with a taxable estate in excess of his remaining applicable exclusion amount, an estate tax will have to be paid prior to funding a testamentary dynasty trust.

# B. Exempt and Non-Exempt Dynasty Trusts

If an amount in excess of the decedent's unused GST exemption is contributed to the trust, the trust should always be divided into two trusts. One trust will have the decedent's remaining GST exemption allocated to it. This trust is referred to as an "exempt trust." Any amount in excess of the decedent's remaining GST exemption will be distributed to a "non-exempt trust." 16

Whether formed during life or at death, an "exempt trust" is typically structured so that the assets can pass from one generation to the next without the imposition of an estate tax. The key is not to give a beneficiary sufficient right or control over the trust assets so as to cause inclusion of the assets in the beneficiary's gross estate. A beneficiary can be given rights that almost equate to ownership without these rights requiring estate tax inclusion. For example, a beneficiary could be named as the trustee of the trust and be given a right to all the income and the right to consume principal limited by an ascertainable standard, which can relate to the beneficiary's support in the beneficiary's accustomed manner of living. Additional flexibility can be given to the beneficiary to address future circumstances by giving the beneficiary a testamentary non-general power to appoint the assets of the trust to anyone in the world, provided that the power to appoint cannot be made ex-

<sup>15.</sup> Priv. Ltr. Rul. 2001-20-021 (Feb. 13, 2001).

<sup>16.</sup> I.R.C. § 2654(b) (2000); Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 562, 115 Stat. 89 (2001) (amending section 2642(a) to allow the severing of a single trust into an exempt and non-exempt trust on a fractional basis beyond the period of time in which severance is permitted in the final regulations).

<sup>17.</sup> Treas. Reg. § 20.2041-1(c)(2) (as amended in 1961).

ercisable in favor of the beneficiary, the beneficiary's creditors or creditors of the beneficiary's estate. The trust assets can be appointed either outright or in trust. If the appointment is made in trust, this trust can give succeeding beneficiaries the same rights previously mentioned. If the beneficiary is entitled to income and principal pursuant to an ascertainable standard, the beneficiary should not be given an intervivos non-general power of appointment because the exercise of that power will constitute a gift by the beneficiary. The beneficiary of the beneficiary of the beneficiary.

A dynasty trust typically includes a non-skip individual as a beneficiary (usually a child or someone only one generation removed). It is ordinarily better to expose a non-exempt trust to the estate tax in a non-skip beneficiary's estate rather than having it subjected to the GST tax when the assets are distributed to skip beneficiaries. The estate tax is progressive and will generally be lower than the flat GST tax. To accomplish this, there could be a savings clause in which a non-skip beneficiary is given a testamentary general power of appointment if a generation-skipping transfer would occur at the death of the non-skip beneficiary. Giving the non-skip beneficiary a testamentary general power of appointment will cause the trust assets to be included in the non-skip beneficiary's taxable estate.<sup>20</sup> If the non-skip beneficiary decides not to exercise the testamentary general power of appointment and the trust assets continue in trust for the benefit of the original settlor's descendants, then the non-skip beneficiary will be considered the transferor for GST tax purposes. A decision can then be made whether to allocate the deceased non-skip beneficiary's GST exemption to the dynasty trust.

# III. CREDITOR PROTECTION AND FOUR DIFFERENT DRAFTING TECHNIQUES

In addition to protecting the trust assets from taxes, the dynasty trust will usually be structured in a manner that protects the trust assets from claims brought by a beneficiary's creditors. The seminal case sanctioning the settlors' ability to create trusts wherein beneficial interests could be protected from creditor claims is the United States Supreme Court case *Nichols v. Eaton.*<sup>21</sup> The following passage in that opinion sanctified spendthrift protec-

<sup>18.</sup> *Id.* § 20.2041-1(c)(1).

<sup>19.</sup> Priv. Ltr. Rul. 94-51-049 (Sept. 22, 1994).

<sup>20.</sup> I.R.C. § 2041(a)(2) (2001) (bringing all property subject to a general power of appointment into the donee's gross estate).

<sup>21. 91</sup> U.S. 716 (1875); see also RESTATEMENT (THIRD) OF TRUSTS § 58 cmt. a (Tentative Draft No. 2, 1999).

tion: "Why a parent ... who ... wishes to use his own property in securing [his child] ... from ... the vicissitudes of fortune and even his own improvidence or incapacity for self-protection, should not be permitted to do so, is not readily perceived."<sup>22</sup>

If the goal is to provide as much creditor protection as possible, the trust must contain a spendthrift provision with respect to the beneficial interests held in trust. A spendthrift provision will provide that the interest of a beneficiary cannot be either voluntarily or involuntarily transferred before the trustee's delivery of the interest to the beneficiary.<sup>23</sup> Alaska Statutes section 34.40.110(b) explicitly states that a creditor may not satisfy its claim out of a beneficiary's interest in trust except in those circumstances listed in that subsection, all of which apply to the settlor and not to the beneficiary.<sup>24</sup> In Alaska, a valid spendthrift provision will protect the trust assets from claims brought by the beneficiary's creditors as long as the assets remain in trust. The protection ends once the assets are distributed to the beneficiary. However, this limited protection is extremely valuable. Once a creditor obtains a judgment against a debtor, the creditor will typically have a writ of execution issued against the property of the debtor.<sup>25</sup> If the creditor is unable to satisfy a claim out of the debtor's beneficial interest, then the creditor must wait until the trustee chooses to make a distribution to the beneficiary. There is no statutory authority in Alaska for the proposition that a creditor's writ of execution can act as a continuing lien against future distributions that a trustee would choose to make to a beneficiary.<sup>26</sup>

In states other than Alaska, the protection available for beneficiaries against creditor claims is dependent on the beneficiary's

<sup>22.</sup> Nichols, 91 U.S. at 727.

<sup>23.</sup> Alaska Statutes section 34.40.110 states, in pertinent part, that in restricting transfers of trust interests:

<sup>(</sup>a) A person who in writing transfers property in trust may provide that the interest of a beneficiary of the trust may not be either voluntarily or involuntarily transferred before payment or delivery of the interest to the beneficiary by the trustee.

ALASKA STAT. § 34.40.110(a) (Michie 2000).

<sup>24.</sup> The circumstances in which a beneficiary's interest may be attached by the settlor's creditors are when (1) the transfer in trust was fraudulent with respect to the settlor's creditors; (2) the settlor has the power to unilaterally revoke the trust; (3) a trust requires that all or a part of the trust's income or principal must be distributed to the settlor; or (4) the settlor is in default for payments due under a child support order. *Id.* § 34.40.110 (restricting transfers of trust interests).

<sup>25.</sup> Id. § 09.35.030.

<sup>26.</sup> *Id.* § 09.38.035 (stating that a writ of garnishment operates as a continuing lien but is effective only with respect to earnings owed the debtor).

entitlement to trust distributions, the beneficiary's ability to control those distributions and, most importantly, applicable state law. On one end of the spectrum, the beneficiary might be a discretionary beneficiary with no definable right to distributions. Creditor protection is at its greatest in a discretionary trust because the beneficiary is not entitled to receive distributions and is also unable to control the decision-making process about who may receive distributions. At the other end of the spectrum, the settlor may want to give the beneficiary an entitlement to trust distributions and also the ability to exercise control over the trust, recognizing that some creditor protection may be lost in the process.

This section of the Article discusses four different ways to structure the beneficial interest. However, these methods are not the only available approaches. In each example, unless otherwise stated, it is presumed that a separate trust will be established for a single primary beneficiary. A single primary beneficiary is defined as an individual entitled to a current distribution of principal or income, as opposed to a pot trust in which there could be any number of beneficiaries. Furthermore, in each example it is presumed that the beneficial interest will be subject to the spendthrift protection of Alaska Statutes section 34.40.110(b).<sup>27</sup> A typical spendthrift clause might read as follows:

With respect to each and every trust created by the terms of this instrument, a beneficiary may disclaim or release his or her interest in principal or income, but no beneficiary shall anticipate, assign, encumber, or subject to any creditor's claim or to legal process, any interest in principal or income before its actual receipt by the beneficiary. The beneficial and legal interests in this trust, its principal, and its income shall be free from interference or control of any beneficiary's creditor and shall not be subject to claims of any such creditor or liable to attachment, execution, bankruptcy or other process of law. The spendthrift provisions enunciated in Alaska Statutes section 34.40.110 specifically apply to each and every trust created by the terms of this instrument.

A. Naming an Independent Trustee and Giving the Beneficiary a Discretionary Interest Not Subject to a Standard, Coupled with a Spendthrift Provision

A beneficial interest describing a discretionary interest not subject to a distribution standard follows:

<sup>27.</sup> *Id.* § 34.40.110(b).

The trustee *may* pay over or apply the net income and principal thereof, to such extent, including the whole thereof, and in such manner or manners and at such time or times and in such amounts and proportions, as the trustee, in the exercise of its sole and absolute discretion, may determine, to or for the benefit of the beneficiary during the lifetime of the beneficiary. Any net income not so paid over or applied shall be accumulated and added to the principal of the trust at least annually and thereafter shall be held, administered and disposed of as a part thereof.

1. Discretionary Trusts in General. The best way to protect a beneficial interest is to give an independent trustee the ability to make discretionary distributions to the beneficiary.<sup>28</sup> The Second Restatement takes the position that a beneficial interest cannot be attached by a creditor if the beneficial interest is discretionary.<sup>29</sup> Nor can the interest of a discretionary beneficiary be reached by a spouse or child for alimony or support by a creditor who provides necessary supplies or services to the beneficiary or by a governmental unit that may have a claim against the beneficiary.<sup>30</sup> The nature of the interest provides the protection; a creditor cannot compel payment because the beneficiary cannot compel payment.<sup>31</sup> However, what is gained in creditor protection is lost in beneficiary control.

The draft of the Third Restatement takes a dramatically different position with respect to the creditor protection available to a beneficiary of a discretionary trust. The Third Restatement provides that regardless of how the discretionary trust is worded, if the

<sup>28.</sup> The concept of the independent trustee is critical in determining who can serve as a trustee if the powers of the trustee are not to be attributed to the settlor or beneficiary for tax purposes. For purposes of this Article, the term is defined as an individual or corporation that is neither related nor subordinate to the settlor or beneficiary within the meaning of I.R.C. section 672(c). Specifically, that section defines the term "related or subordinate party" as any nonadverse party who is

<sup>(1)</sup> the grantor's spouse if living with the grantor;

<sup>(2)</sup> any one of the following: The grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive.

I.R.C. § 672(c) (2001).

<sup>29.</sup> RESTATEMENT (SECOND) OF TRUSTS § 155(1) (1959).

<sup>30.</sup> Id. § 157.

<sup>31.</sup> Id. § 155 cmt. b.

settlor's purpose is to provide for the beneficiary's needs, and if it is acceptable social policy that the beneficiary not be left without support, then the trustee would be subject to a general standard of reasonableness in determining whether a distribution should be made to a beneficiary.<sup>32</sup> A beneficiary's need for support usually includes the needs of those who might be dependent on the beneficiary.<sup>33</sup> Thus, children, spouses and ex-spouses would be able to compel the trustee to make distributions to them in such an amount as would be considered equitable under the circumstances.<sup>34</sup>

It is evident that a loss of creditor protection would occur in a discretionary trust if a dynasty jurisdiction adopts the new position of the Third Restatement. It is also important to note the Uniform Trust Code, as passed by the National Conference of Commissioners on Uniform State Laws on August 3, 2000, takes the same position as the Third Restatement regarding discretionary trusts. In fact, the Uniform Trust Code adopts nearly every position taken in the Third Restatement with respect to the manner in which trust assets can be protected from claims brought by a creditor against the beneficiary of a trust.<sup>35</sup>

Alaska provides superior creditor protection, in part because Alaska's statutory spendthrift law protects the trust against claims brought by creditors that the Third Restatement and Uniform Trust Code might otherwise allow. As explained below, the spendthrift protection in Alaska Statutes section 34.40.110(b) protects the trust assets against most, if not all, creditor claims, regardless of whether trust distributions are within the trustee's discretion or whether the trustee is required to make distributions to the beneficiary.

2. Discretionary Trusts Coupled with a Spendthrift Provision. A discretionary interest coupled with a spendthrift provision merely prevents the discretionary interest, as vague as it may be, from being either voluntarily or involuntarily transferred. If there is no spendthrift clause and the beneficiary transfers his discretionary interest, the trustee will be liable to a creditor for any distributions the trustee makes to the beneficiary after notice that the

<sup>32.</sup> RESTATEMENT (THIRD) OF TRUSTS § 60 cmt. a (Tentative Draft No. 2, 1999).

<sup>33.</sup> *Id*.

<sup>34.</sup> Id.

<sup>35.</sup> UNIF. TRUST CODE §§ 502-03 (2000). As will be explained, section 505(b) of the Uniform Trust Code differs from the position taken in the Third Restatement.

beneficial interest has been transferred to the creditor. Thus, the spendthrift provision protects the trustee of a discretionary trust who wants to make a distribution to an improvident beneficiary but is unable to do so because the beneficiary had previously transferred his discretionary interest.

- 3. Removing the Independent Trustee. One of the principal problems in giving an independent trustee the ability to make discretionary distributions to a beneficiary is there is no easy way to remove an unwanted independent trustee. Giving a discretionary beneficiary the unqualified right to remove and replace the independent trustee comes dangerously close to creating both an estate tax problem and a creditor protection problem, as will be discussed below.
- a. The Tax Problem. From a tax perspective, the problem is to avoid having the trustee's power to make discretionary distributions, not limited by an ascertainable standard, attributed to the beneficiary. If this power is so attributed, the beneficiary will be considered to have a general power of appointment. If the beneficiary has a general power of appointment, then the trust assets will be included in the beneficiary's estate. Estate Tax Regulation section 20.2041-1(b)(1) provides that if under the terms of the trust instrument, the trustee or his successor has the power to appoint the principal of the trust, in a manner that is not limited by an ascertainable standard, for the benefit of individuals including himself, and a beneficiary has the *unrestricted* power to remove or discharge the trustee at any time and appoint any other person including himself as trustee, then the beneficiary has a general power of appointment.<sup>36</sup> On the other hand, the power of the trustee to appoint the principal of the trust will not be attributed to the beneficiary if the beneficiary can remove the trustee "for cause."

It is unclear if a discretionary beneficiary with an unrestricted power to remove the trustee is considered to have a general power of appointment if the beneficiary can only replace a trustee with another independent trustee. In the past the I.R.S. has attributed the powers of the trustee with discretionary powers of distribution to a settlor, who retained the power to remove an independent trustee without cause and appoint a new independent trustee. The underlying assumption of the I.R.S. was that every trustee, including a corporate trustee, would be compelled to follow the bidding of a settlor who has the unrestricted power to remove the trustee

<sup>36.</sup> Treas. Reg. § 20.2041-1(b) (as amended in 1961) (emphasis added).

<sup>37.</sup> Rev. Rul. 79-353, 1979-2 C.B. 325 (1979).

because the settlor will always be able to find another corporate trustee to act as the settlor wishes.

This argument that the independent trustee will invariably do the settlor's bidding failed in *Estate of Wall v. Commissioner*.<sup>38</sup> The reason this argument failed is because it disregarded the fact that the trustee would violate the fiduciary duty it owes beneficiaries if it takes action that the trustee would not otherwise take merely because the trustee could be replaced.<sup>39</sup> As a result of this decision, the I.R.S. pronounced a new position in Revenue Ruling 95-58, finding that a settlor's power to remove and replace an independent trustee, who has the power to make discretionary distributions, with another independent trustee will not cause the trust assets to be brought back into the settlor's taxable estate under I.R.C. sections 2036 and 2038.<sup>40</sup>

Despite the holding of Revenue Ruling 95-58, it is still uncertain whether a discretionary beneficiary can have unrestricted power to remove an independent trustee and replace him with another independent trustee without causing the trust assets to be brought back into the beneficiary's estate. In a private letter ruling, which cannot be used as precedent by other taxpayers, the I.R.S. stated that a beneficiary can have the power to remove and replace an independent trustee of a wholly discretionary trust with another independent trustee without the trustee's discretionary powers of distribution being attributed to the beneficiary.<sup>41</sup>

However, this ruling does not adequately differentiate between those I.R.C. sections applicable to a settlor and those that are applicable to a beneficiary. The issue for a settlor is whether or not the retained power to change the corporate trustee can be equated with a power to designate the persons who are to possess or enjoy the trust property. Possession or enjoyment would require the trust assets to be included in the settlor's estate. It is the fiduciary duty that the trustee owes to the beneficiaries, which remains unaffected by the settlor's removal and replacement power, that prevents the attribution of the trustee's actions to the settlor.

When a beneficiary has an unqualified power to remove and replace the trustee, the issue is whether the beneficiary indirectly has the power to consume, invade or appropriate property for his benefit. Arguably, it is possible for a trustee of a discretionary trust to make a complete distribution of the trust assets to a beneficiary, having the power to remove and replace the trustee, without

<sup>38. 101</sup> T.C. 153, 159 (1993).

<sup>39.</sup> Id.

<sup>40.</sup> Rev. Rul. 95-58, 1995-2 C.B. 191 (1995).

<sup>41.</sup> Priv. Ltr. Rul. 97-46-007 (Aug. 11, 1997).

the trustee violating its fiduciary duties. As a result, a beneficiary may not be able to make the same argument that was made by the settlor in *Estate of Wall* that the trustee's fiduciary duty remains unaffected by a beneficiary's power to remove and replace the trustee. In fact, in subsequent rulings the I.R.S. now appears to be leaning towards the position that a discretionary beneficiary with an unqualified power to remove an independent trustee, but having only the power to replace the removed trustee with another independent trustee, is nonetheless considered to have a general power of appointment with respect to the trust assets.<sup>42</sup>

b. The Creditor Protection Problem. Aside from the potential tax problem, if maximum creditor protection is desired, a discretionary beneficiary should not be given an unrestricted power to remove and replace the independent trustee with another independent trustee out of concern that the trustee's power to make discretionary distributions will be attributed to the beneficiary. If the beneficiary has the power to make discretionary distributions to himself, which is not limited by an ascertainable standard, a beneficiary's creditor could easily make the argument that the entire assets of the trust should be made available to the creditor.

Instead of giving a discretionary beneficiary an unrestricted power to remove and replace the independent trustee, the trust instrument could name a trust protector who has an unrestricted power to remove and replace the independent trustee. The trust protector would need to be independent of the beneficiary within the meaning of I.R.C. section 672(c). The difficulty with using a trust protector is that dynasty trusts can extend beyond the lifetime of anyone in existence at the time the trust is established. As a result, the built-in limitation exists that this individual will not be around for future generations of trust beneficiaries. One solution is to give the initial trust protector the ability to appoint a successor trust protector who in turn has the power to appoint a successor trust protector.

How does one remove an unwanted trust protector? It would appear dangerous for both tax and creditor protection reasons to give a discretionary beneficiary the *unrestricted* power to remove and replace a trust protector with another trust protector for the same reasons that the beneficiary should not be given the unrestricted power to remove and replace an independent trustee. It

<sup>42.</sup> Priv. Ltr. Rul. 2000-31-008 (Apr. 18, 2000); Priv. Ltr. Rul. 2000-20-010 (Feb. 15, 2000); Priv. Ltr. Rul. 2000-24-011 (Mar. 7, 2000).

<sup>43.</sup> I.R.C. § 672(c) (2001) (defining who or what is a related or subordinate party).

would be far too easy to impute the distribution authority of the independent trustee to the beneficiary if the beneficiary has the *unrestricted* power to remove and replace a trust protector, who in turn has the *unrestricted* power to remove and replace the independent trustee.

To protect against tax and creditor protection problems, if a discretionary beneficiary is given the power to remove the trustee it should only be "for reasonable cause." A list of items that constitute reasonable cause should be included. Preferable still, if a discretionary trust is involved, it would be prudent to include an independent trust protector, giving the trust protector the sole authority to remove the trustee. The trust protector could have an unrestricted right to remove the trustee, but it would be far safer, at least for creditor protection purposes, to limit the removal power "for reasonable cause." If a trust protector is named, a discretionary beneficiary should not have the power to remove the trust protector but only the power to appoint a successor trust protector should the original trust protector resign.

<sup>44.</sup> Priv. Ltr. Rul. 93-03-018 (Oct. 23, 1992). In this private letter ruling, the I.R.S. considered acceptable (i) the legal incapacity of the trustee; (ii) the willful or negligent mismanagement by the trustee of trust assets; (iii) the abuse or abandonment of, or inattention to, the trust by the trustee; (iv) a federal or state charge against the trustee involving the commission of a felony or serious misdemeanor; (v) an act of stealing, dishonesty, fraud, embezzlement, moral turpitude or moral degeneration by the trustee; (vi) the trustee's use of narcotics or excessive amounts of alcohol; (vii) the trustee's poor physical, mental or emotional health that causes the trustee to be unable to devote sufficient time to administer the trust; (viii) the trustee's failure to comply with a written agreement regarding compensation or any other legally enforceable written agreement affecting the trust's operation; (ix) the failure of a corporate trustee to appoint a senior officer with at least five years of experience in administering trusts to handle the account; (x) changes by a corporate trustee in the account office responsible for handling the trust account more frequently than every five years; (xi) the relocation of the trustee away from the location where the trust operates so as to interfere with the administration of the trust; (xii) a demand for unreasonable compensation; or (xiii) any other reason for which a court of competent jurisdiction would remove a trustee.

B. Naming an Independent Trustee and Entitling the Beneficiary to Distributions Relating to the Beneficiary's Health, Education, Maintenance and Support, Coupled with a Spendthrift Provision

A beneficial interest naming an independent trustee but entitling the beneficiary to distributions relating to an ascertainable standard could be drafted in the following manner:

The trustee *shall* pay over or apply the net income and principal thereof, to such extent, including the whole thereof, as the trustee may determine necessary for the beneficiary's health, education, maintenance and support in the beneficiary's accustomed manner of living.

If it is decided that it is better to give the beneficiary a right to trust distributions, the trustee could be instructed to make distributions limited to an ascertainable standard relating to the health, education, maintenance and support of the beneficiary. The Second Restatement takes the position that "support" trusts cannot be reached by a beneficiary's general creditors, with or without spendthrift protection, because it is the nature of the beneficiary's interest rather than a provision forbidding alienation that prevents the transfer of the beneficiary's interest. 46 In other words, trust assets may only be used for the restricted purpose set forth in the trust (i.e. the beneficiary's support). Nonetheless, the Second Restatement does provide an exception for certain special claimants, such as children, spouses and ex-spouses, suppliers of necessaries and governmental units who can reach the beneficial interest in satisfaction of their claims.<sup>47</sup> Even then, a court must first determine what might reasonably be available to the beneficiary without unduly affecting the interests of remainder beneficiaries, as well as the beneficiary's own needs.<sup>48</sup>

The Second Restatement goes on to say that the interest of a beneficiary may be reached in other cases if considerations of public policy so require.<sup>49</sup> It specifically mentions that it might be possible for a person who has a claim in tort to reach the beneficiary's interest in trust.<sup>50</sup> The Mississippi Supreme Court alluded to this

<sup>46.</sup> RESTATEMENT (SECOND) OF TRUSTS § 154 (1959).

<sup>47.</sup> Id. § 157(a).

<sup>48.</sup> See id. at cmt. b.

<sup>49.</sup> Id. at cmt. a.

<sup>50.</sup> *Id*.

exception in *Sligh v. First National Bank*,<sup>51</sup> where the court held that the trust assets could be attached by a creditor of a discretionary beneficiary, even though the creditor's claim defeated the remainderman's interests.<sup>52</sup> Interestingly, Mississippi's own legislature rejected the holding of its highest court by passing a law within six months that effectively overturned the precedential value of this decision.<sup>53</sup> The decision in *Sligh* was an aberration as demonstrated by the commentary contained in the Third Restatement, which, as far-reaching as it is in protecting creditor rights, soundly rejects the holding of the *Sligh* case as being excessive and inappropriate because the holding defeated the remainderman's interest.<sup>54</sup>

The advantage of an Alaska dynasty trust is that the spend-thrift protection of Alaska Statutes section 34.40.110(b) prevails over the claims of all creditors not specifically exempted in the statute, irrespective of whether the creditor is a special claimant as defined in the Second and Third Restatements. However, so as not to confuse what the settlor may have intended when providing that the trustee shall make distributions to the beneficiary for his support in his accustomed manner of living, it would be best to provide the additional restriction that only the support needs of the beneficiary may be considered, and not the needs of those dependent upon the beneficiary.

From a purely tax perspective, there is no problem in giving a beneficiary who is entitled to distributions limited to an ascertainable standard that relates to the beneficiary's health, education, maintenance and support an unrestricted right to remove and replace an independent trustee with another independent trustee.

<sup>51. 704</sup> So.2d 1020 (Miss. 1997). Curiously, the trust established for the beneficiary was a discretionary trust and one must wonder why the court even became involved with the spendthrift issue.

<sup>52.</sup> Id. at 1029.

<sup>53.</sup> MISS. CODE ANN. § 91-9-509 (Supp. 2001).

<sup>54.</sup> See RESTATEMENT (THIRD) OF TRUSTS § 60 cmt. f (Tentative Draft No. 2, 1999). The following example is given in the Third Restatement: F devised property to T to pay such amounts of income to or for support and welfare of his son, B, and to distribute the trust estate upon B's death to his issue. B's interest has been attached by a creditor, who has a very large property and personal injury judgment against B resulting from an automobile accident. If it were determined that payment of the claim would result in a significant impairment of the remainderman's interest, the trustee could decide not to make a distribution to the claimant. The conclusion one draws is that in the Third Restatement only where the beneficiary was engaged in malicious or reckless behavior, and only after taking into account other beneficial interests, could a beneficiary's interest in trust be partially or entirely distributed to a tort claimant.

<sup>55.</sup> ALASKA STAT. § 34.40.110(b) (Michie 2000).

The beneficiary will not be considered as having a general power of appointment over the trust assets that would cause estate tax inclusion.<sup>56</sup>

C. Naming the Beneficiary as Trustee and Giving the Beneficiary a Discretionary Interest Limited to an Ascertainable Standard Relating to a Beneficiary's Health, Education, Maintenance and Support, Coupled with a Spendthift Provision

A dynasty trust could name a beneficiary as the sole trustee, but the beneficial interest would be a discretionary interest limited to an ascertainable standard relating to a beneficiary's health, education, maintenance and support. The beneficial interest could be described as follows:

The trustee may pay over or apply the net income and principal thereof, to such extent, including the whole thereof, as the trustee, in the exercise of sole and absolute discretion, may determine, for and limited to the beneficiary's health, education, maintenance and support in the beneficiary's accustomed manner of living. Any net income not so paid over or applied shall be accumulated and added to the principal of the trust at least annually and thereafter shall be held, administered and disposed of as a part thereof. The limitation that payments may be made or applied only for the beneficiary's health, education, maintenance and support in the beneficiary's accustomed manner of living shall not be interpreted as imposing a duty, even if unreasonably withheld, on the trustee to make distributions for the beneficiary's health, education, maintenance and support in the beneficiary's accustomed manner of living, but shall only set forth the maximum extent in which the trustee's exercise of discretion may be exercised. Moreover, only the support needs of the beneficiary may be considered and not the needs of those dependent upon the beneficiary.

At the other end of the continuum regarding beneficiary control, the beneficiary could serve as his own trustee, and he could be entitled to discretionary distributions limited to an ascertainable standard relating to the beneficiary's health, education, maintenance and support. This type of trust is sometimes referred to as a "beneficiary-controlled" dynasty trust. <sup>57</sup> Care must be taken that

<sup>56.</sup> Treas. Reg. § 20.2041-1 (as amended in 1961).

<sup>57.</sup> R. OSHINS & S. OSHINS, Protecting & Preserving Wealth into the Next Millennium (pt. 1), 137 TRUSTS AND ESTATES 11, at 52, 60 (1998).

the limitation (that distributions can be made only for the beneficiary's health, education, maintenance and support in the beneficiary's accustomed manner of living) is not interpreted as setting forth a standard that requires the trustee to make distributions to the beneficiary. In other words, the limitation should set forth only a ceiling, and not a floor, in which the range of discretion may be employed. The Second Restatement does not give the creditor more rights if a beneficiary has been named as the sole trustee of his trust, see presumably because he would be subject to the same fiduciary standards (particularly those that might be owed to remaindermen) as would be applicable to an independent trustee. As previously mentioned, under the Second Restatement, only special claimants such as children, spouses and ex-spouses, providers of necessaries and governmental units would have a right to reach the interest of the beneficiary in satisfaction of their claims.

The position taken in the Third Restatement differs markedly with regard to the rights of creditors against a beneficiary who is a trustee of his own trust. The Third Restatement's position is that spendthrift provisions are disregarded when the beneficiary is also the trustee. The result is that not only do the special claimants referred to above have a right to reach the beneficial interest, but any claimant can reach the maximum amount that the beneficiary could distribute to himself without the distribution being considered an abuse of discretion.<sup>59</sup> The Third Restatement states any fiduciary position that the beneficiary occupies can be disregarded, and it describes the beneficiary's fiduciary rights as a limited form of ownership analogous to certain general powers.<sup>60</sup> These rather harsh results do not apply if an independent co-trustee is appointed. In jurisdictions where a current beneficiary cannot serve as sole trustee without leaving the trust vulnerable to creditor claims, it would be desirable to name an independent co-trustee who would be solely responsible for distributions.

The advantage of the Alaska dynasty trust, irrespective of the position taken in the Second or the Third Restatement, is that a beneficiary can be named as the trustee of his own trust, and the spendthrift protection of Alaska Statutes section 34.40.110(b) would prevail over the claim of a creditor, special claimant or otherwise. In addition, its simplicity in approach may make the trust more palatable to the settlor and the beneficiary who does not

<sup>58.</sup> RESTATEMENT (SECOND) OF TRUSTS § 152 cmt. m (1959).

<sup>59.</sup> RESTATEMENT (THIRD) OF TRUSTS § 60 cmt. g (Tentative Draft No. 2, 1999).

<sup>60.</sup> Id.

<sup>61.</sup> *Id*.

want an independent trustee to become involved in the family's financial matters.

# D. A Blended Approach with an Independent Trustee as Either a Successor Trustee or an Originally Appointed Co-Trustee

In sum, the basic theme of the three previous approaches is that in jurisdictions where creditor protection is desired and adequate spendthrift protection cannot be provided, it is best for the trust to be discretionary and for the trustee to be independent. Even though it is not necessary to have an independent trustee in order to have creditor protection in Alaska, if maximum creditor protection is desired, it is probably wise to have an independent trustee who has the sole power to make discretionary distributions. One approach is to draft a trust in which the beneficiary as the sole trustee can make discretionary distributions to himself limited to an ascertainable standard relating to the beneficiary's health, education, maintenance and support in his accustomed manner of living, but further providing that in the event of his resignation as trustee, an independent trustee would replace him as the trustee. An alternative approach is to make the beneficiary-trustee a cotrustee with another independent trustee from the outset.

The advantage of the first approach is that it gives the beneficiary control when creditor protection is not a concern and gives the beneficiary the ability to turn over control should a creditor concern arise in the future. The disadvantage of this approach is that it might appear that the beneficiary has transferred something of value by resigning as a trustee in favor of an independent trustee, especially if the resignation comes shortly after a creditor problem arises. It should be mentioned that this perceived disadvantage has no legal foundation, since a beneficiary who serves as a trustee is still a fiduciary, and the spendthrift protection of Alaska Statutes section 34.40.110(b) does not differentiate on the basis of who is serving as trustee. Alternatively, the trust instrument could provide that upon the beneficiary relinquishing his position as sole trustee, an independent co-trustee named in the instrument would thereupon be appointed. The independent co-trustee would have the sole authority to make distributions, with the beneficiary being retained as a co-trustee with the authority over investments and the administrative aspects of the trust. In order to provide a jurisdictional nexus to Alaska, it is important that the administrative functions of the trust be served by an Alaskan trustee.<sup>62</sup>

The second, and perhaps better, approach is to have the beneficiary serve at the outset as a co-trustee with an independent trustee, where the independent trustee has the sole authority concerning distributions. The beneficiary could continue to have authority concerning investments and, provided the beneficiary is domiciled in Alaska, authority over the administrative aspects of the trust. At any point in time, the beneficiary could relinquish the investment and administrative functions in favor of an independent trustee. Having an independent trustee solely responsible for distribution decisions from the outset would be the preferred approach if there is concern that a subsequent resignation of the beneficiary as the sole trustee in favor of an independent trustee would compromise the protection given the beneficial interest. The right to remove and replace the independent trustee could continue to be given to the beneficiary, provided the beneficial interest is not wholly discretionary but is limited to an ascertainable standard. However, it is preferable for both tax and creditor protection purposes to give the beneficiary the power to remove the independent trustee only "for reasonable cause," as defined in the trust document.

#### IV. POWERS OF APPOINTMENT

# A. Powers of Appointment and Creditor Claims

As previously mentioned, dynasty trusts exempt from the GST tax will typically give beneficiaries a testamentary non-general power of appointment. A testamentary non-general power of appointment allows a beneficiary to alter the disposition of assets as set forth in a settlor's dispositive plan. Giving beneficiaries powers of appointment resolves, in many respects, the argument against dynasty trusts that property interests should be controlled by the living and not by a settlor's "dead hand." 63

As might be expected, appointive assets covered by a testamentary non-general power of appointment cannot be attached by a beneficiary's creditor or the expenses of administration of a beneficiary's estate.<sup>64</sup> Even if a beneficiary is given a testamentary *general* power of appointment, as would typically be the case in a non-exempt dynasty trust, the trust assets cannot be subjected to the claims of the beneficiary's creditors, unless and only to the extent

<sup>63.</sup> See Ira Mark Bloom, The GST Tax Tail is Killing the Rule Against Perpetuities, 87 TAX NOTES 569, 570-71 (2000) (providing a discussion of past and present reasons for the rule).

<sup>64.</sup> RESTATEMENT (SECOND) OF PROP.: DONATIVE TRANSFERS § 13.1 (1986).

provided by statute. <sup>65</sup> It is important to note that the tax goal of having the assets of a non-exempt trust included in the beneficiary's estate can be accomplished without the donee being considered the owner of the trust for creditor protection purposes. <sup>66</sup> This is the Second Restatement's position as it relates to both an unexercised testamentary general power of appointment and an unexercised but presently exercisable general power of appointment. The theory is that until the donee exercises the power, he has not accepted control over the appointive assets that gives the donee the equivalent of ownership. <sup>67</sup> However, under the Second Restatement if a testamentary or a presently exercisable general power of appointment is exercised, the appointive assets can be subjected to the payment of claims against the beneficiary's estate. <sup>68</sup>

The Third Restatement differs from the Second Restatement in that it treats an individual with an unexercised but presently exercisable general power of appointment as the owner of the property over which the rights could be exercised. A presently exercisable right of withdrawal is treated as a presently exercisable general power of appointment. Thus, all assets that could be withdrawn by the donee of a presently exercisable general power of appointment are subject to claims of the beneficiary's creditors. This arguably could compromise irrevocable trusts where a beneficiary is given *Crummey* withdrawal rights. Under the Third Restatement, during the time a beneficiary has withdrawal rights, the trust is considered self-settled to the full extent that the beneficiary has such withdrawal rights. The Uniform Trust Code differs from the Third Restatement in this regard by considering the trust self-

<sup>65.</sup> Compare R.I. GEN. LAWS § 34-22-13 (1956), with RESTATEMENT (SECOND) OF PROP.: DONATIVE TRANSFERS § 13.2 (1986) (going further than the Restatement by specifically rejecting creditor claims against donees of a power of appointment, whether non-general or general).

<sup>66.</sup> I.R.C. § 2041(a) (2001).

<sup>67.</sup> RESTATEMENT (SECOND) OF PROP.: DONATIVE TRANSFERS § 13.2 (1986).

<sup>68.</sup> *Id.* § 13.4, 13.5.

<sup>69.</sup> RESTATEMENT (THIRD) OF TRUSTS § 56 (1959).

<sup>70.</sup> See Crummey v. Comm'r of Internal Revenue, 397 F.2d 82 (9th Cir. 1968), rev'g Crummey v. Commissioner, 25 T.C.M. (CCH) 772 (1966). To qualify a gift for the annual exemption the gift must be of a present interest. Typically gifts in trust are not of a present interest because the beneficiaries have only a future right to the gift as dictated by the terms of the trust. To convert what would otherwise be a gift of a future interest into a gift of a present interest that qualifies for the gift tax annual exemption, beneficiaries are given an immediate right to withdraw the settlor's contribution to the trust for a limited period of time. Typically this is thirty to sixty days. If the right is not exercised, it lapses, and the contribution remains in the trust to be used as the trustee directs.

settled only to the extent the withdrawal right exceeds the greater of \$5,000 or 5% of the trust estate or the gift tax annual exclusion amount. To the extent a trust is considered self-settled, under both the Third Restatement and the Uniform Trust Code, any spendthrift restraint will be held invalid as to that portion subject to a beneficiary's withdrawal rights, leaving the trust assets vulnerable to the beneficiary's creditors. This will not be the result under Alaska law because self-settled trusts are recognized in Alaska, but this is only true if the beneficiary interest is discretionary.

### B. Powers of Appointment and the Delaware Tax Trap

Generally, the exercise of a testamentary non-general power of appointment will not result in the trust assets being included in the gift or estate tax base of the beneficiary who exercises that power. An exception exists when the beneficiary exercises a testamentary non-general power of appointment in a manner that causes the beneficiary to fall into the "Delaware Tax Trap." The Delaware Tax Trap is sprung in a state that has totally eliminated the Rule Against Perpetuities if a beneficiary exercises a nongeneral power of appointment to create a further trust, giving a successive beneficiary a non-general power of appointment. The result is that all trust assets subject to the exercise of the beneficiary's non-general power of appointment are exposed to the gift or estate tax, depending on when the beneficiary exercised the nongeneral power of appointment. This exposure could prove devastating to the beneficiary who unwittingly falls into the trap. This deficiency in Alaska state law brought about the enactment of Alaska's present Rule Against Perpetuities, as well as a new rule governing the suspension of the power of alienation.<sup>74</sup>

To fully understand the Delaware Tax Trap, one must first have a basic understanding of the Rule Against Perpetuities and the manner in which powers of appointment fit into this rule.<sup>75</sup> The

<sup>71.</sup> Unif. Trust Code § 505(b)(2) (2000).

<sup>72.</sup> RESTATEMENT (THIRD) OF TRUSTS § 58 illus. 2, 11 (Tentative Draft No. 2, 1999); UNIF. TRUST CODE § 505.

<sup>73.</sup> ALASKA STAT. § 34.40.110(b)(3) (Michie 2000).

<sup>74.</sup> Id. § 34.27.051. This statute was signed into law on April 22, 2000, but is retroactive to April 2, 1997. In addition, the new Alaska Statutes section 34.27.100 added a rule governing the suspension of the power of alienation. These provisions were amended again by the twenty-second Legislature, and the amendments were signed into law on April 28, 2001, effective immediately.

<sup>75.</sup> For a thorough discussion of the Delaware Tax Trap, see Stephen E. Greer, *The Delaware Tax Trap and the Abolition of the Rule Against Perpetuities*, Est. Plan., Feb. 2001, at 68.

common law Rule Against Perpetuities and the USRAP both provide that the validity of an interest in trust created by the exercise of a non-general or testamentary general power of appointment is measured from the date the original trust was created. Thus, the measuring period for determining the validity of non-vested interests created by the exercise of a non-general or a testamentary general power of appointment "relates back" to the date the original trust was created.<sup>77</sup> The "relation back" doctrine not only determines the inception of the time period in which trust interests must vest, but it also determines the inception of the time period in which non-general and testamentary general powers of appointment must be exercised. As a result, under both the common law Rule Against Perpetuities and the USRAP, when the donee of a non-general power of appointment (the first power) exercises it by giving a beneficiary the further ability to exercise a non-general power of appointment (the second power), the time period in which an interest created by the second power must vest is measured by calculating the perpetuities period from the date of the trust instrument creating the first power.<sup>79</sup>

In a jurisdiction that has abolished the Rule Against Perpetuities, there is no stated period of time within which a property interest must vest. Whenever a power of appointment is exercised to create a successive non-general power of appointment, the property subject to this power will have its vesting postponed for a period of time that cannot be ascertained by referring back to the date of the instrument creating the first power of appointment. "There is no 'period' ascertainable by reference to the date [a]... power was created, because there is no rule against perpetuities and thus there simply is no 'period." Thus, all trust property subject to the exercise of a non-general power of appointment, exercised to create a trust giving a succeeding beneficiary a nongeneral power of appointment, renders that property subject to federal estate tax or federal gift tax.

<sup>76.</sup> See Lawrence W. Waggoner, Estates in Land and Future Interests in a Nutshell  $\S\S 16.1(d), 16.2$  (2d ed. 1993).

<sup>77.</sup> The "relation back" doctrine does not apply to a presently exercisable general power of appointment, which is the equivalent of ownership for perpetuities purposes. *See id.* § 16.1(d).

<sup>78.</sup> See RESTATEMENT (SECOND) OF PROP.: DONATIVE TRANSFERS § 1.2(h) (1986).

<sup>79.</sup> UNIF. STAT. RULE AGAINST PERPETUITIES § 2 (amended 1990), 88 U.L.A. 359 (1993).

<sup>80.</sup> STAFF OF HOUSE COMM. ON REAL PROPERTY & PROBATE, 2000 Leg., 21st Sess., Analysis HB 599, at 4 (Fla. 2000).

#### C. Evolvement of Alaska Law to Avoid the Delaware Tax Trap

Alaska's first attempt to permit the creation of dynasty trusts was in 1997. Alaska Statutes section 34.27.050 was amended to state that "a nonvested property interest is invalid unless the interest is in a trust, and all or part of the income or principal of the trust may be distributed, in the discretion of the trustee, to a person who is living when the trust is created." Under the terms of that statute, several problems were discovered.

First, it was unclear whether a charitable lead dynasty trust could be created in Alaska. This is a trust in which a charity is given a right to receive an annuity or unitrust interest, usually for a term of years, followed by a gift-over to non-charitable beneficiaries. The transfer tax value of the ultimate gift-over to the settlor's non-charitable beneficiaries must be actuarially reduced to take into account the charity's interest. This is an effective way to reduce the federal transfer tax on the amount that the non-charitable beneficiaries will ultimately receive. Under the terms of the former statute, it was unclear whether the gift-over to the non-charitable beneficiaries could be in the form a dynasty trust because it was unclear whether a charity was a "person" within the meaning of the statute. If charities were not included in the definition of a "person," then the unrepealed USRAP provisions would apply with respect to the future interests of the non-charitable beneficiaries.

Second, there was an additional concern that it might not be possible to create dynasty trusts that are initially funded with assets in which beneficiaries are given *Crummey* withdrawal rights. <sup>82</sup> If the gift to the trustee is subject to an immediate right of withdrawal free from interference by the trustee, then under the terms of the statute, income or principal cannot be distributed in the trustee's discretion to a person who is living when the trust is created. This is because the trustee cannot make a distribution of trust assets during the time the beneficiaries have withdrawal rights and thus the trust cannot be perpetual. Instead, the trust interests would have to vest within the period set forth in USRAP.

Third, although under the former statute a trust could be perpetual with no requirement that beneficial interests vest within the period set forth in USRAP, there was also no required period within which property "must" vest. Therefore, if a beneficiary exercised a non-general power of appointment to create a trust giving a successive beneficiary a non-general power of appointment, the

<sup>81.</sup> ALASKA STAT. § 34.27.050(a)(3) (repealed 2000).

<sup>82.</sup> Crummey v. Comm'r of Internal Revenue, 397 F.2d 82 (9th Cir. 1968), rev'g Crummey v. Commissioner, 25 T.C.M. (CCH) 772 (1966).

property subject to this power would have its vesting postponed for a period of time not ascertainable by referring back to the date of the instrument creating the first power of appointment. As a result, a beneficiary who exercised the non-general power of appointment fell into the Delaware Tax Trap. However, it was doubtful a beneficiary would ever fall into the Delaware Tax Trap because of an equally troublesome problem. The former statute left in place a USRAP provision that contingent non-general powers of appointment could be validly exercised only within the USRAP period. As a result, any attempt to exercise a non-general power of appointment to create a successive non-general power of appointment beyond the statutory period permitted under USRAP would simply be invalid.

It was important to do two things so that non-general powers of appointment could be safely given to beneficiaries of dynasty trusts. First, the time period of the Rule Against Perpetuities needed to be extended instead of abolished so that there would be a period of time within which property subject to a non-general power of appointment, exercised to create a successive power of appointment, must vest; second, the length of time within which powers of appointment could be exercised must be extended to that same period of time. On April 22, 2000, the former USRAP provisions were repealed, and Alaska Statutes section 34.27.051 was enacted in its place. 83 Alaska Statutes section 34.27.051 states that non-general and testamentary powers of appointment must be exercised within 1,000 years from the date of the instrument creating the original power of appointment.84 This same section states that in the limited circumstance where a non-general power of appointment is exercised to create a successive non-general power of appointment or a successive testamentary general power of appointment, all property interests must vest within 1,000 years of the creation of the original instrument creating the original nongeneral power of appointment.<sup>85</sup>

Because the ability of a beneficiary to fall into the Delaware Tax Trap might be desirable if it is better to have the property subjected to estate or gift tax rather than generation-skipping tax, as is typically the case in non-exempt trusts, this was explicitly pro-

<sup>83.</sup> See H.R. 34, 22 Leg., 1st Sess. (Alaska 2001); S. 162, 21 Leg., 1st Sess. (Alaska 2000).

<sup>84.</sup> ALASKA STAT. § 34.27.051(a) (Michie 2000).

<sup>85.</sup> *Id.* § 34.27.051(c).

vided for in Alaska Statutes section 34.27.051(b).86 In that subsection, a new perpetuities period commences when a presently exercisable power of appointment is created.<sup>87</sup> These new provisions were retroactive to April 2, 1997, at the time when perpetual trusts became possible in Alaska.88 The ability to make these provisions retroactive is sanctioned in section 5(a) of USRAP.<sup>89</sup> This section provides that with respect to a non-vested property interest and a power of appointment created by the exercise of a power of appointment, the law in effect at the time a power of appointment is exercised to create a successive power of appointment controls. In other words, even though a trust instrument might have been created prior to the enactment of USRAP, if at a later point in time a power of appointment is exercised, the law in effect at the time the power of appointment is exercised determines the validity of the exercise and the validity of all interests created by that exercise. The purpose of that provision was to make USRAP's "wait and see" period of ninety years applicable to trust instruments created prior to the enactment of USRAP.

In addition to radically changing our Rule Against Perpetuities, a new rule against the suspension of the power of alienation (the "Alienability Rule") was passed. This rule actually promotes the same goals as the common law Rule Against Perpetuities. The primary aim is to make the trust property freely alienable within a defined period of time. In fact, many states have abolished the Rule Against Perpetuities in favor of an Alienability Rule. Those states are Illinois, Maine, Maryland, New Jersey, Ohio, South Dakota, and Wisconsin. The central purpose behind the Rule Against Perpetuities is to require all future interests to vest within a required period of time. Once all interests have vested, it is possible, particularly when a trust is not involved, to value those interests so the property can then be sold. The Alienability Rule was interpreted to mean the following—not later than the end of a

<sup>86.</sup> Jonathan G. Blattmachr & Jeffrey N. Pennell, *Adventures in Generation-Skipping, or How We Learned to Love the "Delaware Tax Trap,"* 24 REAL PROP., PROB. & TR. J. 75, 87-88 (1989); ALASKA STAT. § 34.27.051(b) (Michie 2000).

<sup>87.</sup> Alaska Stat. § 34.27.051(b).

<sup>88.</sup> *Id.* § 34.27.070(c).

<sup>89.</sup> UNIF. STATUTORY RULE AGAINST PERPETUITIES § 5(a) (amended 1990), 8b U.L.A. 375 (1993).

<sup>90.</sup> ALASKA STAT. § 34.27.100 (Michie 2000).

<sup>91. 765</sup> ILL. COMP. STAT. 305/4(a)(2) (West Supp. 2001); ME. REV. STAT. ANN. tit. 33, § 101-A (West Supp. 2000); MD. CODE ANN., [Estates & Trusts] § 11-102 (2001); N.J. STAT. ANN. § 46:2F-9 (West Supp. 2001); Ohio Rev. Code Ann. § 2131.09 (West 1994); S.D. Codified Laws § 43-6-3 (Michie 1997); Wis. STAT. Ann. § 700.16 (West 2001).

permissible period, there must exist persons in being who, alone or in combination with others, can convey an absolute fee in land or full ownership of personalty. The test is whether the trust would or could end during the permissible period, thus providing the beneficiaries the ability to sell the trust assets. 22 As originally formulated, the power of alienation had to reside in the beneficiaries. The requirement that the beneficiaries be given the power of sale has been statutorily changed in those states adopting the Alienability Rule. In these states, there is either an explicit or implicit statement that the power of alienation is not suspended with respect to property held in trust if a trustee is given a power of sale over the trust assets. Alaska Statutes section 34.27.100 states that the power of alienation must not be suspended beyond a period measured by lives in being plus thirty years. 93 At the same time, this statute provides that the power of alienation is not suspended if a trustee is given a power of sale over the subject property.<sup>94</sup>

In Alaska, the principal reason for the adoption of the Alienability Rule is to ensure the alienability of property held in trust, and also to fit within the holding of Estate of Murphy v. Commissioner. In Estate of Murphy, a beneficiary of a Wisconsin trust exercised a power of appointment by creating another power in her husband, which he in turn could validly exercise by placing the property subject to the power in a perpetual trust for the benefit of his children and descendants.<sup>96</sup> The federal government's position was that the Delaware Tax Trap provisions of I.R.C. section 2041(a)(3) applied.<sup>97</sup> However, the tax court held that section 2041(a)(3) required only an examination of applicable local law to determine whether there was a postponement of vesting or a suspension of the power of alienation. The court found section 2041(a)(3) inapplicable because the trustee was given a power of sale. 99 Under Wisconsin law, the permissible alienation period is measured from the date the first power is created. Where the

<sup>92.</sup> I. Bloom, *Transfer Tax Avoidance: The Impact of Perpetuities Restrictions Before and After Generation-Skipping Taxation*, 45 ALBANY L. REV. 261 (1981) (discussing the history of the Rule Against Perpetuities and the rule against the suspension of the power of alienation).

<sup>93.</sup> ALASKA STAT. § 34.27.100 (Michie 2000). This additional thirty-year period corresponds to Wisconsin law. WIS. STAT. ANN. § 700.16(1)(a) (West 2001).

<sup>94.</sup> Alaska Stat. § 34.27.100(b)(2)(A) (Michie 2000).

<sup>95. 71</sup> T.C. 671 (1979), acq. in result, 1979-2 C.B. 2.

<sup>96.</sup> Id. at 672-73.

<sup>97.</sup> Id. at 678.

<sup>98.</sup> Id. at 680.

<sup>99.</sup> Id. at 673 n.5.

<sup>100.</sup> Id. at 681.

trustee is given a power of sale, the power of alienation is not suspended for a period of time that cannot be ascertained by referring back to the date of the instrument creating the original power of appointment. This is for the simple reason that the power of alienation is never suspended, not even for a day. Thus, it is impossible to fall into the Delaware Tax Trap. The new Alienability Rule was adopted in the event a tax court would find Alaska's 1,000 year vesting period as being tantamount to an abolishment of the Rule Against Perpetuities. Should that occur, under the Alienability Rule dynasty trusts would still be protected from the Delaware Tax Trap under the holding of *Estate of Murphy* to which the I.R.S. has acquiesced. Delaware Tax Trap under the holding of *Estate of Murphy* to which the I.R.S. has acquiesced.

## V. WILL ALASKA LAW CONTROL THE RULE AGAINST PERPETUITIES AND SPENDTHRIFT ISSUE FOR A NON-RESIDENT BENEFICIARY?

Which state law controls when an Alaskan settlor has an Alaska governing law provision, but the beneficiaries reside in other states? The answer to this question is critical to the settlor because the underlying reason for creating the trust is to take advantage of Alaska law regarding the Rule Against Perpetuities and spendthrift protection. <sup>103</sup>

## A. The Rule Against Perpetuities Issue

The Second Restatement of the Conflict of Laws provides that questions concerning the Rule Against Perpetuities are questions of substantial validity. The Restatement's position is that the validity of a trust is determined by the local law of the state designated by the settlor, provided the state has a substantial relation to the trust. With respect to intervivos dynasty trusts, there is a substantial relation to the state if the settlor is a domiciliary of the state when the trust is established. In the case of a testamentary trust, the applicable law is that of the state where the settlor died. Thus, Alaska law will control the Rule Against Perpetuities issue when an Alaskan establishes an intervivos irrevocable dynasty trust

<sup>101.</sup> Although only in a rare trust would a trustee not be given the power of sale, it would be wise to specifically grant this power in any dynasty trust.

<sup>102. 71</sup> T.C. 671, acq. in result, 1979-2 C.B. 2.

<sup>103.</sup> This Article does not address the ability of a settlor who was never a resident of Alaska to designate Alaska as the controlling law.

<sup>104.</sup> RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 270 cmt. d (1971).

<sup>105.</sup> *Id.* § 269(b)(i).

<sup>106.</sup> Id. § 269 cmt. f.

<sup>107.</sup> *Id*.

and when an Alaskan testator has established a dynasty trust in his will. However, what if a testator creates a dynasty trust in his will while domiciled in Alaska and thereafter moves and dies in another state that has not abolished the Rule Against Perpetuities? Which state law controls for purposes of determining the Rule Against Perpetuities—Alaska's or the law of the state where the settlor dies? The Restatement's position is that the Alaska Rule Against Perpetuities provision would continue to be valid in the subsequent state, even though it would be invalid as violating the perpetuity law of the testator's domicile.<sup>108</sup>

### B. The Spendthrift Issue

There is an additional question as to whether a settlor's Alaska choice-of-law provision concerning Alaska spendthrift protection for the beneficiary will be upheld if the beneficiary is a non-resident of Alaska. The controlling law for determining spend-thrift protection is the law of the state where the trust administration occurs. Thus, if the trust administration occurs in Alaska, the Alaska spendthrift provision will be upheld even if the beneficiaries are non-residents of Alaska. This result will occur even though the trust lacks a specific provision indicating where the trust is to be administered if the settlor names an Alaskan trustee.

# C. Does Alaska Statutes Section 13.36.035(c) Impose an Additional Requirement Before Alaska Law Can Apply?

Alaska Statutes section 13.36.035(c) provides that Alaska law governs the validity, construction and administration of an Alaskan trust. Moreover, a provision designating Alaskan law as controlling is valid, effective and conclusive for the trust, as long as one has a trustee who is a "qualified person." A "qualified person" is defined as an Alaska trust company or an Alaskan individual.<sup>114</sup>

<sup>108.</sup> *Id.* § 269 cmts. i, j.

<sup>109.</sup> Id. § 273.

<sup>110.</sup> Id. at cmt. a.

<sup>111.</sup> Id.

<sup>112.</sup> Id. at cmt. c.

<sup>113.</sup> ALASKA STAT. § 13.36.035(c) (Michie 2000).

<sup>114.</sup> Under Alaska Statutes section 13.36.390(2), a "qualified person" means (A) an individual who, except for brief intervals, military service, attendance at an educational or training institution, or for absences for good cause shown, resides in this state, whose true and permanent home is in this state, who does not have a present intention of moving from this state, and who has the intention of returning to this state when away;

The question then becomes whether Alaska Statutes section 13.36.035(c) was intended to be the exclusive means through which Alaska law could apply. Nothing in the language of section 13.36.035(c) suggests that this statute sets forth the exclusive means for an Alaska choice-of-law provision to be upheld. Under the general conflict of law principles set forth in the Second Conflict of Laws Restatement, a settlor who has a nexus with Alaska (because the settlor dies with Alaska as his domicile) or who had a nexus with Alaska (because the settlor was domiciled in Alaska at the time the trust was executed) could justifiably expect an Alaskan governing law provision to be upheld with respect to perpetuity issues despite not having an Alaskan trustee. 115 It would seem implausible that section 13.36.035(c) would upset this expectation because the legislative intent behind section 13.36.390 was to provide non-residents with a statutory nexus to Alaska so that Alaskan law would apply to their trusts. 116

Nonetheless, to avoid any controversy as to whether Alaska law is meant to govern both the perpetuities and spendthrift issues, six provisions are suggested. First, there should be a governing law provision providing that the validity and construction of all rights under the document are governed by the law of Alaska. Second, there should be a direct expression of intent that the administration of the trust should occur in Alaska. Third, there should always be one trustee who is a qualified person as defined in Alaska Statutes section 13.36.390(2).<sup>117</sup> Fourth, the duties of that trustee shall, at a minimum, include the duty and responsibility to maintain the books and records of the trust and to prepare or to arrange for the preparation of the trust's tax returns. Fifth, at least some of the trust's assets should be deposited in Alaska; and sixth, it should be specifically stated that the spendthrift provisions enunciated in Alaska Statutes section 34.40.110 apply to each and every trust created by the terms of the instrument.

ALASKA STAT. § 13.36.390(2) (Michie 2000).

<sup>(</sup>B) a trust company that is organized under [Alaska Statutes section] 06.25 and that has its principal place of business in this state; or

<sup>(</sup>C) a bank that is organized under [Alaska Statutes section] 06.05, or a national banking association that is organized under 12 U.S.C. 21 - 216d, if the bank or national banking association possesses and exercises trust powers and has its principal place of business in this state.

<sup>115.</sup> RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 269 (1971).

<sup>116.</sup> ALASKA STAT. §§ 13.36.035(c), 13.36.390 (Michie 2000).

<sup>117.</sup> *Id.* § 13.36.035(c).

<sup>118.</sup> *Id.* § 34.40.110.

#### VI. DRAFTING IN LIGHT OF EGTRRA

As indicated throughout this Article, EGTRRA has changed the tax environment in which an estate plan drafter must work. Undoubtably, the tax environment will continue to experience change. The following two observations concern the drafting of dynasty trusts in light of EGTRRA.

First, estate plans must remain flexible to meet future needs of the beneficiaries and to avoid unintended and unforeseen tax consequences. In this regard, an important provision is the ability of an independent trustee to change the terms of the trust, particularly those that are tax driven, should an amendment be advisable. Alaska law now permits the beneficiaries to go to court to change the terms of a trust to avoid an unintended or unexpected tax result. However, this still requires the involvement of a court. It would be far more expedient to give an independent trustee the non-judicial power to change the terms of the trust.

Second, section 542 of EGTRRA adds new I.R.C. section 1022(d)(1)(B)(iii), which becomes effective in 2010. The significance of the provision is that property over which the decedent holds a power of appointment will not be eligible for the limited basis adjustment available at death under EGTRRA. It may be important for a beneficiary to give his heirs the advantage of a basis adjustment at death, particularly if all transfer taxes are eliminated and the only tax left is the income tax. After first considering any tax consequences to the beneficiaries, a method of accomplishing this, and at the same time providing future flexibility, is to give an independent trustee the power to terminate the trust by making a distribution of the trust assets to the then current beneficiary.

#### VII. CONCLUSION

Alaska's new Rule Against Perpetuities keeps Alaska on the cutting edge of the nationwide trust industry. States that have fallen into the Delaware Tax Trap when they abolished their Rule Against Perpetuities or other states that are contemplating abolishing their Rule Against Perpetuities will look upon the Alaska statutes as a model to emulate.<sup>121</sup> When one considers that the

<sup>119.</sup> *Id.* §§ 13.36.345-13.36.390.

<sup>120.</sup> Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 542, 115 Stat. 38, (to be codified at I.R.C. § 1022(a)-(b)).

<sup>121.</sup> Arizona, Colorado, Delaware, Idaho, Rhode Island and Virginia have all fallen into the Delaware Tax Trap. *See* Stephen E. Greer, *The Delaware Tax Trap and the Abolition of the Rule Against Perpetuities*, EST. PLAN., Feb. 2001, at 68.

Delaware Tax Trap does not operate as a threat to an Alaskan dynasty trust, as it does in other jurisdictions that permit dynasty trusts, and also the extent to which an Alaskan dynasty trust can protect a beneficiary against claims brought by the beneficiary's creditors, there is probably no jurisdiction superior to Alaska in which to form a dynasty trust.