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Trusts Without Beneficiaries

Planning With Purpose Trusts

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It would be difficult to find an estate planning attorney who does not know the three basic elements of a trust: a trustee, a corpus, and one or more beneficiaries. The presence of a beneficiary is regarded by many commentators as the most important, since without a beneficiary there would be no one to enforce the trust and hence there could be no trust[1], but for one notable exception. That is, a charitable trust may have no beneficiaries, per se, but it is well-settled law that a charitable trust will not fail on that account because the attorney general of the applicable jurisdiction has the power to enforce the trust. Thus, even though we have a trust with no beneficiaries (e.g., a trust established for scientific research), it will not fail for lack of a beneficiary.

Up to now, this concept has presented a serious problem for would-be settlors who wish to create trusts for pets, for example, or to maintain family property or sustain a family business. Such trusts, considered to be established for a purpose rather than for beneficiaries, would fail as non-charitable purpose trusts. With the advent, however, of the Uniform Trust Code, the Uniform Probate Code, and the global implementation of purpose trusts from various jurisdictions, such as Bermuda, the Cayman Islands, and the Bahamas, all this may change.

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Concept and Background

Briefly, a purpose trust is one established for a purpose rather than for specified beneficiaries. The difference for this discussion is that the purpose of the trust would be non-charitable. An example of a non-charitable purpose trust would include one which is established to maintain the settlor's collection of antique automobiles, or perhaps one for the purpose of constructing a home for the maintenance and care of his cats and dogs and all their offspring. As noted earlier, a charitable trust, although it has no named beneficiaries, may be enforced by the local attorney general. In the foregoing examples, however, certainly neither the antique automobiles nor the cats and dogs could sue the trustee to enforce the trust, and none of them is capable of having a personal representative. A trust (as we know it) must have beneficiaries whose identity can be established with certainty. If the identity or method of determination of the ultimate beneficiaries of a trust is so vague that neither the trustee nor a court could readily determine whether any given individual at any time was or was not a beneficiary, the trust would be unenforceable under common law and therefore, invalid, unless, of course, its purpose was charitable.[2]

By and large, in the past, the laws of the various states in the U.S. have followed the English rule, refusing to recognize trusts without beneficiaries,[3] even though there may ultimately be identifiable beneficiaries after the non-charitable purpose was satisfied. For instance, in the illustration above, a purpose trust could be established for the maintenance of the settlor's collection of automobiles, and if and when the automobiles were unusable or disposed of, or simply after a set period of time, the trust would terminate, and the settlor's children would receive any assets (e.g., the automobiles) remaining in the trust. The fact that the children may be designated remaindermen after the purpose is carried out does not change the character of the trust nor by itself give it validity as a trust. In those U.S. jurisdictions which do not recognize purpose trusts, a trust with these provisions (i.e., a non-charitable purpose) generally would be totally disregarded as void, and one of two things would happen. Either the bequest would pass directly to the children (remaindermen) without regard to the instructions to maintain the automobiles, or the entire bequest would fail and pass by intestacy in the settlor's estate. Cases have held both ways.[4]

Although there are some U.S. states that have adopted a form of purpose trust law, it is in a far more limited way than the offshore jurisdictions, and it appears to be primarily to suit the "pet" (animal) trust objective.[5] That is to say, the thrust in the U.S. to adopt purpose trust legislation appears to be largely related to and motivated by the public's desire to be able to establish valid trusts for their pets, although other "honorary" trusts (such as trusts to maintain gravesites or say masses) are usually allowed on the same theory. The popularity of pet trusts is clearly reflected in the 1993 amendment to the Uniform Probate Code ("UPC"), section 2-907 (b). That section, which is optional for states adopting the code, specifically acknowledges and validates honorary trusts and trusts for pets, but of the two categories, it distinguishes trusts established for pets in greater detail, in apparent recognition of a strong public interest in establishing such trusts. Further, the California and Colorado statutes, fashioned after the UPC, both contain specific provisions under which trusts for pets can be valid.[6] Contrast this focused, limited purpose legislation with the broad and flexible purpose trust legislation found in the offshore jurisdictions mentioned above, where the question of pet trusts could hardly be less relevant.

U.S. purpose trusts are also allowed in the states which have adopted the Uniform Trust Code ("UTC"). Section 409 of that code provides that: "a trust for a non-charitable purpose without a definite or definitely ascertainable beneficiary or for a non-charitable purpose to be selected by the trustee is valid". The UTC goes on, however, to limit the term of such a (purpose) trust to 21 years. Interestingly, the wording of the UTC does not invalidate the trust after the 21 year period, it merely declares it to be unenforceable. Presumably, then, a court, upon a petition, could declare the trust invalid, inasmuch as its terms are then unenforceable. When that happens, unless otherwise provided in the trust, the corpus would revert to the settlor or her estate. It would be unusual if not a lack of foresight if a drafter did not provide for disposition of the trust property at the end of the 21 year period, or after the purpose was carried out, or in the event it could not be carried out.

A few states allow some form of purpose trust through case law (e.g., Pennsylvania[7]), but whether through case law or a uniform code, the application and use of purpose trusts in the U.S. is extremely narrow and the term of the trust unnecessarily limited. For instance, if an individual wished to provide for the long term maintenance of a private building without mingling that asset with other assets in a "person" trust (one which provided for individual beneficiaries, where dispositive disputes could arise and restraint on sale of the property could be overridden), why should he be limited to 21 years? Fortunately, some states, including Massachusetts, have lengthened the allowable term.

Massachusetts Law

Under the Massachusetts UTC, Section 409 was adopted without the 21 year limitation, so that the term of a purpose trust established in Massachusetts would presumably be subject to the Massachusetts rule against perpetuities (Mass Gen. Law. Ch. 109 B, Act. II, Sec. 2-901). But Mass UTC Section 409 has another limitation giving the court authority to limit the funding of the trust to an amount that the court determines is adequate for the trust's "intended use." Thus, if a purpose trust is funded with $10 million for the purpose of maintaining a cottage that costs $5,000 a year to maintain, a court will likely cut the funding down to $1 or $2 million, and the rest will pass to the settlor's "successors in interest." Similar rules apply to trusts for pets.

Offshore Purpose Trusts for U.S. Purposes

Accordingly, If a U.S. person wished to establish a purpose trust with a broader scope and for a longer term than permitted in the U.S. states that allow such trusts, it would be a relatively straightforward matter to settle one in any of the several offshore jurisdictions recognizing such purpose trusts, and then administer it in the U.S. (sometimes referred to as "importing the law").

Depending on the purpose of the trust and the situs of the trust assets, the purpose trust established offshore but administered here should be honored by U.S. courts, as it is well-settled law that a settlor of an inter-vivos trust may designate the jurisdiction whose law will apply to the validity and administration of the trust.[8] Associated with this rule, however, is the requirement that there be some "nexus" between the designated law and the trust itself.[9] In the case of the purpose trust containing intangibles, this should not present a problem, since, if necessary, the intangibles, or even a portion of them, could be moved to the desired jurisdiction to establish the nexus.[10] Furthermore, since most of the offshore jurisdictions require a "local" trustee to serve, this would clearly establish the necessary nexus to apply the law of the jurisdiction designated by the settlor. It is also important to note that if the only asset of the foreign purpose trust is U.S. real estate, a U.S. court may hesitate to apply foreign law to its administration, unless it is found that the trust does not violate the strong public policy of the situs state.[11] A simple solution to this concern would be to place the real estate in a limited liability company (LLC) with the trustee of the purpose trust as the sole member.

Which Offshore Jurisdiction?

As to which jurisdiction to select, there are, of course, numerous factors to consider both domestic and offshore, including the purpose and term of the trust, the most logical place for administration, the laws of the respective jurisdictions under consideration (i.e., the flexibility of the applicable statute), and perhaps, the client's travel preferences.

In point of fact, the purpose trust statues of the offshore jurisdictions and their fundamental requirements of the trust are quite similar in substance. While the purpose trust law of Bermuda, the Cayman Islands, and the British Virgin Islands are generally regarded as the most thoughtful, it would be difficult to say that one is much better than another for most purposes. Thus, the selection of jurisdiction or governing law may be based on offshore contacts that the client and/or the advisor may have, selection of initial trustee, fees, and perhaps the client's travel preferences.

Requirements For A Valid Purpose Trust

In order for a purpose trust to be enforceable, it must meet certain requirements, sometimes boiled down to three:

1. The purpose must be certain, reasonable, and attainable;
2. The purpose must not be against public policy; and
3. The trust must be capable of enforcement (typically through an enforcer or protector).

These requirements are typical throughout the purpose trust jurisdictions[12] and for purpose trusts in general.

U.S. Income Tax Issues

Those attorneys familiar with the establishment of trusts in jurisdictions other than the U.S. will agree it is a relatively simple matter to form a purpose trust for a U.S. client in a selected offshore jurisdiction and then make the transfer of desired assets to the offshore trust, including a U.S. account in the name of the offshore trust. In the typical case, the trust is drafted so that the transfer to the trust is tax neutral for U.S. tax purposes and the income is taxed to the grantor (i.e., a "grantor trust" under Internal Revenue Code (IRC) sections 671-679), so there should be no new taxes to worry about (though pursuant to IRC section 6048 and Rev. Procedure 97-37, there are Internal Revenue Service (IRS) information forms that must be filed to avoid substantial penalties where a foreign trust is concerned. See comments below.)

Due to the fact that a purpose trust has no beneficiaries, however, if the trust is drafted so that it is not a U.S. grantor trust, some tricky, if not odd tax considerations apply. For instance, IRC sections 641 and 651 provide for a deduction for amounts that a trust distributes to a beneficiary, and corresponding sections 642 and 652 provide that the beneficiary receiving such distributions shall include such distributions in his or her gross income. But what happens to these rules in the case of a purpose trust that distributes income for the upkeep of an automobile or the care of a cat? Obviously neither the car nor the cat will be filing a tax return, and it wouldn't seem fair that the trust should simply be denied the distribution deduction and taxed at the higher trust tax rates, since it is not accumulating the income. On the other hand, to allow a deduction for trust distributions that are not taxed to anyone just won't fly under U.S. tax laws.

Under U.S. income tax laws, if a trust is treated as a grantor trust, then the deductibility of trust distributions becomes unimportant, because all income, losses, credits, etc. are passed through the trust and the person deemed to be the grantor (typically the settlor of the trust) is treated as the taxpayer. The trust, though recognized for all other purposes, is ignored for U.S. income tax purposes, and the grantor trust may be a domestic trust or a foreign trust[13]. Clearly, this would be the easier way to do it. It is also important to note that if the trust is a foreign trust but not a grantor trust, the settlor will be exposed to a capital gain tax on the transfer of appreciated assets to the trust under IRC sect. 684, although most advisors are successful in avoiding this merely by adding one or another of the grantor trust provisions.

If the trust is not treated as a grantor trust (which would be highly unlikely if it is a foreign trust and the settlor is alive, on account of the IRS's likely application of I.R.C. section 679), then no U.S. income tax may be due until distributions are made, but the IRS has not ruled on distributions from a purpose trust for a U.S. "object." The great likelihood is that such trusts would be treated as benefiting the U.S. persons connected with or benefiting from the object or purpose of the trust.

US Reporting Requirements

If an offshore purpose trust is established, it is important to understand and advise the client as to his or her reporting requirements. Briefly, settlors who establish such trusts and beneficiaries who receive distributions (even indirectly as noted above) are required to file Form 3520 on those events, and the trustee is required to file form 3520A. In addition, if the trust is a grantor trust and has more than $10,000 in foreign accounts or foreign "financial assets", the grantor must file Fin CEN Form 114 annually. If the amount exceeds $50,000 ($100,000) for joint filers, Form 8938 must also be filed. **Note** that this is an abbreviation of the filing requirements for Form 8938 as well as the other forms and not a substitution for investigating the actual reporting requirements for each case.

Review of Grantor vs. Non-Grantor Purpose Trust U.S. Tax Consequences

To review the principles illustrated above, if the purpose trust is a grantor trust,[14] then all of the income will be taxed to the grantor, and if the funding of the trust was not a completed gift, the grantor will be deemed to have made gifts as the funds are distributed. Even though the trust distributions may be made directly to individuals (as opposed to objects) for the trust purpose, gift tax exposure would still result.[15] For instance, under a purpose trust to provide for the care of a horse, a distribution to a handler for the care of the horse would not be a taxable gift to the handler or to the horse (though it may be income to the handler), but it would be a gift nonetheless.[16] A distribution from a grantor-type purpose trust to a corporation for the preservation or continuation of the business is normally a gift to the shareholders in proportion to their interests.[17] A distribution from a purpose trust for the maintenance of a building owned by the trust may not appear to be a gift to anyone, but under IRC section 2501 it is a gift nonetheless, and as noted below it does not qualify for the annual exclusion. Further, use of trust funds for improvements on the building could be treated by the IRS as a gift to the remaindermen if the original transfer was not a completed gift and if the trust remains a grantor trust as to principal.

If the trust is a non-grantor trust and the funding of the trust was a completed gift, no additional gifts would result when trust distributions were made in furtherance of the purpose, but the practitioner must be mindful, as always, of any generation-skipping tax issues that may apply. As observed above, however, where distributions are made from the non-grantor purpose trust to a closely held corporation, there would be a different result. That is, if a trust distribution of income is made from a non-grantor purpose trust to a closely held corporation, the corporation, unlike an animal or other non-taxpayer, is a taxable entity, and as a trust "beneficiary", it will be subject to income tax on the distribution. (The corporation would be treated as a beneficiary only for U.S. tax purposes, as the purpose trust does not have beneficiaries, per se.) In such a case, the trust should be entitled to a distribution deduction under IRC sections 641 and 651.

As far as U.S. estate taxes are concerned, as pointed out below, the question of inclusion generally hinges more on whether certain powers or benefits were retained than on whether or not the trust is a grantor trust. For instance, if a settlor reserves the right in a non-fiduciary capacity to withdraw trust assets by substituting trust assets of equal value, this would cause the trust to be treated as a wholly grantor trust as to the settlor,[18] but it would not, by itself, cause inclusion of the trust assets in the settlor's estate. Typically, estate tax inclusion of a purpose trust would be the result of the settlor retaining some benefit from the trust, or a power over the trust such as the power to change the purpose of the trust, the power to withdraw trust assets, or the power to add or delete beneficiaries, or to appoint the property either during life or at death.[19]

U.S. Gift and Estate Tax Issues

Even though the trust may be established in an offshore jurisdiction, if the settlor is a U.S. person we still have other U.S. tax laws to think about. For instance, what about U.S. gift tax issues? Is it possible to make a taxable gift to a cat? Not surprisingly, there are virtually no tax rulings or cases shedding any light on the U.S. gift or estate tax issues that may be associated with purpose trusts, primarily because, with the very limited exception discussed earlier, the U.S. states generally do not recognize purpose trusts and even the offshore purpose trust statutes are relatively new. Nevertheless, the author believes that a number of basic tax concepts can be applied to at least make a number of educated guesses.

For instance, as to whether taxable gifts could be made to pets, cars, or buildings, the fact is that except for qualified charities, the federal gift tax laws do not care who the donee might be.[20] Whether a taxable gift is made for gift tax purposes depends on whether the transfer will be treated as a taxable gift (i.e., where the donor has relinquished dominion and control) and not on the identity of the donee.[21] Furthermore, the IRC section 2503(b) annual exclusion from taxable gifts will not apply to purpose trusts, since that code section specifically applies to gifts to "persons."

Accordingly, where an individual settles and funds a purpose trust, the funding of which is not a completed gift because of a reserved benefit or power in the settlor thereby making the trust a grantor trust, <u>all</u> distributions from the trust in furtherance of the trust purpose will be subject to a gift tax and will not be eligible for the IRC 2503(b) annual exclusion. This would be the case, of course, whether or not the actual settlor is identified in the trust instrument, as the tax laws look to the substance rather than the form of the transaction.

Similarly, a transfer to a purpose trust that <u>did</u> constitute a completed gift of income and principal would always be a taxable gift of a future interest, but annual distributions, whether from income or principal, would not be taxable gifts. The yearly income would be taxed to the trust generally without a corresponding deduction (unless, for example, to a corporation or other entity) as pointed out above, but distributions from the trust to carry out its purpose would not be taxable gifts. Even if the trust was a grantor trust, the same gift tax results would apply, but the income would be taxed to the settlor/grantor each year, even though not received by her. The grantor's payment of the tax on trust income is not considered a gift, since the grantor is simply satisfying her liability to pay the tax.[22]

As to estate taxes, as observed above, all the "normal" rules of estate tax inclusion of trusts would apply. For instance, where the settlor reserved the power to appoint the trust property, if that power existed at her death, the property would be included under IRC sections 2036 and 2038. And if the settlor relinquished that power within three years of her death, the property would be included in her estate under IRC section 2035. Of course, in substantial situations, advisors might recommend that clients obtain formal rulings from the Internal Revenue Service.

U.S. Generation Skipping Tax Issues

The purpose trust poses some interesting questions in relation to the generation-skipping transfer ("GST") tax. For one, if we have a "pure" purpose trust that has no individual beneficiaries and can never have individual beneficiaries, there should be no GST tax issues, since the trust does not fall within the definition of a skip-person.[23] On the other hand, this could change dramatically if the purpose of the trust involved distributions to or for the benefit of a non-charitable entity. For instance, a trust for the purpose of advancing the interests of a family business could typically involve distributions to a family corporation. In such a case, for GST tax purposes distributions to the corporation are deemed to be transfers to the owners of the entity.[24] Accordingly, if a skip-person was a shareholder of the corporation the distribution attributable to that shareholder would appear to be a taxable distribution for GST tax purposes.[25] Another problem with this possible outcome is how and when to allocate the transferor's GST tax exemption to the trust, or whether the allocation would be automatic. For certain lifetime transfers, whether by direct skip or by indirect skip, the allocation of the transferor's GST exemption is automatic.[26] With a purpose trust, this may not always be clear, but for purposes of determining whether the skip is direct or indirect, at least we know that the "look-through" rule (to ownership of the entity) does not apply.[27]

For most purpose trusts (other than very short term U.S. purpose trusts established under the Uniform Trust Code or the Uniform Probate Code as discussed earlier), GST issues will be very relevant, since such trusts are typically designed to continue for more than one generation, and seldom, if ever would the trust be designed to pour over (i.e., be included for estate tax purposes) into the estates of children of the settlor (in which case the GST issue would be eliminated). In this regard, practitioners employing purpose trusts must carefully consider all possible GST ramifications that may emanate from the special nature of these trusts.

Conclusion

With the advent of the Uniform Trust Code and the Uniform Probate Code, the purpose trust in the U.S. can offer important new planning possibilities in an estate plan, but if its purpose is for maintenance of a family business or other non-charitable family purpose, the trust should be established in one of the several offshore jurisdictions that have purpose trust statutes. And given the administrative and tax issues with foreign trusts, it may also be wise to consider importing the offshore trust (and its governing law) to the U.S. and causing it to be treated as a U.S. trust for income tax purposes.[28] Where the settlor is a U.S. person, the advisor and drafter must be constantly mindful of the somewhat tricky U.S. income, gift, and estate tax ramifications, even though the trust is to be governed and administered by the law of the selected offshore jurisdiction. That is, so long as the offshore statutory requirements of the purpose trust are met, it may generally be administered anywhere in the world, including the U.S., but if the settlor is a U.S. person, it will still be subject to U.S. tax laws. Therefore, it should be possible to establish a purpose trust in an offshore jurisdiction, and after a short time, move it to the U.S. while retaining the governing law of the original jurisdiction. And as U.S. planners become more and more familiar with purpose trusts, no doubt more and more creative and useful purposes will be found.

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[1] Austin W. Scott and William F. Fratcher, *The Law of Trusts* § 112 (4th Ed., 1989).
[2] George Palmer, *Private Trusts for Indefinite Beneficiaries*, Michigan Law Rev. 359 (Dec. 1972).

[3] Ames, *The Failure of the Tilden Trust*, 5 Harvard L. Rev. 389 (1892).
[4] See, e.g., *In re Renner's Estate*, 57 A.2d 836 (Pa. Super. Ct. 1948); *The Fidelity Title and Trust Company, Executor v. Ethel Clyde*, 121 A.2d 625 (Conn. 1956).
[5] *See, e.g.*, N.Y. Est. Powers & Trusts Law, 7-6.1, Cal. Prob. Code 15212, and Colo. Rev. Stat. Ann. 15-11-901.
[6] *Id*.
[7] *In re Renner's Estate*, 57 A.2d 836 (Pa. 1948).
[8] Scott & Fratcher, *Supra*, note 1 at § 598.
[9] *Id*.
[10] *See e.g.*, *City Bank Farmers Trust Co. v. Cheek*, 93 N.Y. L. J. 2941 (June 7, 1935). *See also Watts v. Swiss Bank Corp.*, 43 Misc. 2d 758 (N.Y. Sup. Ct. 1964), where a settlor domiciled in France established a custodial account in New York and delivered securities to the New York trustee to administer the fiduciary arrangement there under New York law. The arrangement (and selection of governing law) was held to be valid.
[11] *See Peterzell Trust* 7 Pa. D&C 2d 400 (Pa. 1956), holding that a trust established by a California settlor designating California law as governing law of the trust was valid even though the trustee and situs of the trust property was in Pennsylvania. But see also, Scott & Fratcher, *Supra*, note 1 at § 648(1), and *Restatement Second Conflict of Laws* § 277 (1971).
[12] See, e.g., Bermuda Trusts (Special Provisions) Act 1998, Section 12 (A)(2); British Virgin Islands Trustee Ordinance Act (Cap 303) Section 84.
[13] IRC §§ 7701(a)(30)(E) and 7701(a)(31)(B).
[14] IRC §§ 671-679, causing trust income and losses to be passed through to the person or entity treated as the owner for income tax purposes.
[15] Treas. Reg. § 25.2511-1(c)(1).
[16] .Treas. Reg. § 25.2501-1-(a)(1).
[17] Treas. Reg. § 25.2511-1(h)(1).
[18] IRC § 675(4)(c).
[19] *See, generally*, IRC §§ 2035, 2036, and 2038.
[20] We are not unmindful of the fact that different donees may produce different gift tax results, such as gifts to spouses (IRC § 2523) or gifts to trusts with retained interests producing different results based on the relationship of the remaindermen to the donor (IRC § 2702).
[21] Treas. Reg. § 25.2501-1-(a)(1).
[22] Rev. Rul. 2004-64.
[23] IRC § 2613(a).
[24] IRC § 2651(f)(2).
[25] IRC § 2612(b), Treas. Reg. § 25.2511-1(h)(1).
[26] IRC §§ 2632(b) and (c). However, the transferor can elect to "opt out" of the automatic allocation. IRC § 2632(b)(3) and IRC § 2632(c)(5).
[27] IRC § 2612(c)(2).
[28] IRC § 7701(a)(30)(E) and § 7701(a) (31)(B). The offshore trust could be converted to a U.S. trust by adding a U.S. co-trustee or a U.S. protector with powers to make "substantial" decisions in trust administration and a provision that allows the trust to be subject to jurisdiction of a U.S. court.